Internal Revenue
bulletin

Bulletin No. 1998–37
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HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 98–44, page 4.
Section 355. This ruling declares Rev. Rul. 70–225 obsolete because it is no longer determinative following modifications made by the Taxpayer Relief Act of 1997, as amended by the Tax Technical Corrections Act of 1998. Rev. Rul. 70–225 addresses a distribution of the stock of a newly formed controlled corporation followed by an acquisition of the stock of the controlled corporation. Rev. Rul. 70–225 obsoleted.

EXCISE TAX

Ct.D. 2064, page 4.
The Harbor Maintenance Tax of section 4461 of the Code violates the Export Clause by imposing an *ad valorem* fee based on the value of the cargo and not on the use of federal harbor services. United States v. United States Shoe Corporation.

ADMINISTRATIVE

REG–106177–97, page 33.
Proposed regulations under section 529 of the Code relate to Qualified State Tuition Programs (QSTPs). A public hearing will be held on January 6, 1999.

Rev. Proc. 98–47, page 8.
Business expenses; environmental remediation costs; election. Procedures are provided for taxpayers to make the election under section 198 of the Code to deduct any qualified environmental remediation expenditure.

Rev. Proc. 98–49, page 9.
LIFO; price indexes; inventory price computation method. Guidance is provided to taxpayers using the dollar-value last-in, first-out (LIFO) inventory method and the inventory price index computation (IPIC) method regarding the computation of a percent change for an index category that is affected by revisions to the CPI Detailed Report or the PPI Detailed Report.

Rev. Proc. 98–52, page 12.
Electronic filing; magnetic media. Specifications are set forth for the magnetic or electronic filing of 1998 Forms 8027. The forms may be filed with the Service using ½ inch magnetic tape; IBM 3480/3490 or AS400 compatible tape cartridges; or 5 ¼-, 3 ½-inch diskettes and electronic filing through the Information Reporting Program Bulletin Board System (IRB-BBS). Rev. Proc. 92–81 superseded.

Notice 98–47, page 8.
Timely filing or payment; private delivery services. An updated list of designated private delivery services is provided for purposes of section 7502 of the Code. The list remains unchanged from the lists published in Notice 97–50, 1997–37 I.R.B. 21 and Notice 97–26, 1997–1 I.R.B. 413.

Finding Lists begin on page 49.

Department of the Treasury
Internal Revenue Service

Mission of the Service

The purpose of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency, and fairness.

Statement of Principles of Internal Revenue Tax Administration

The function of the Internal Revenue Service is to administer the Internal Revenue Code. Tax policy for raising revenue is determined by Congress.

With this in mind, it is the duty of the Service to carry out that policy by correctly applying the laws enacted by Congress; to determine the reasonable meaning of various Code provisions in light of the Congressional purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a government nor a taxpayer point of view.

At the heart of administration is interpretation of the Code. It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he or she is "protecting the revenue." The revenue is properly protected only when we ascertain and apply the true meaning of the statute.

The Service also has the responsibility of applying and administering the law in a reasonable, practical manner. Issues should only be raised by examining officers when they have merit, never arbitrarily or for trading purposes. At the same time, the examining officer should never hesitate to raise a meritorious issue. It is also important that care be exercised not to raise an issue or to ask a court to adopt a position inconsistent with an established Service position.

Administration should be both reasonable and vigorous. It should be conducted with as little delay as possible and with great courtesy and considerateness. It should never try to overreach, and should be reasonable within the bounds of law and sound administration. It should, however, be vigorous in requiring compliance with law and it should be relentless in its attack on unreal tax devices and fraud.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents of a permanent nature are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
With the exception of the Notice of Proposed Rulemaking and the disbarment and suspension list included in this part, none of these announcements are consolidated in the Cumulative Bulletins.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis and are published in the first Bulletin of the succeeding semiannual period, respectively.

The contents of this publication are not copyrighted and may be reprinted freely. A citation of the Internal Revenue Bulletin as the source would be appropriate.

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Section 355.—Distribution of Stock and Securities of a Controlled Corporation

26 CFR 1.355–2: Limitations.

The revenue ruling declares Rev. Rul. 70–225 obsolete because it is no longer determinative following modifications made by the Taxpayer Relief Act of 1997, as amended by the Tax Technical Corrections Act of 1998. *See* Rev Rul. 98–44, page 4.

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26 CFR 1.355–2: Limitations.
(Also section 7805; 301.7805–1.)

Section 355. This ruling declares Rev. Rul. 70–225 obsolete because it is no longer determinative following modifications made by the Taxpayer Relief Act of 1997, as amended by the Tax Technical Corrections Act of 1998. Rev. Rul. 70–225 addresses a distribution of the stock of a newly formed controlled corporation followed by an acquisition of the stock of the controlled corporation. Rev. Rul. 70–225 obsoleted.

Rev. Rul. 98–44

Rev. Rul. 70–225, 1970–1 C.B. 80, modified by Rev. Rul. 98–27, 1998–22 I.R.B. 4, addresses a distribution of the stock of a newly formed controlled corporation followed by an acquisition of the stock of the controlled corporation. Rev. Rul. 70–225 is no longer determinative following enactment of § 1012 of the Taxpayer Relief Act of 1997, Pub. L. No. 105–34, 111 Stat. 788, 914–18 (the "Act"), as amended in § 6010(c) of the Tax Technical Corrections Act of 1998, Pub. L. No. 105–206, 112 Stat. 790, 813–14, which modified certain provisions in §§ 351, 355, and 368 of the Internal Revenue Code. Subject to certain transition rules, § 1012(c) of the Act is effective for transfers after August 5, 1997.

Accordingly, Rev. Rul. 70–225 is declared obsolete as of the effective date of § 1012(c) of the Act.

DRAFTING INFORMATION

The principal author of this revenue ruling is Phoebe Bennett of the Office of Assistant Chief Counsel (Corporate). For further information regarding this revenue ruling, contact Ms. Bennett at (202) 622-7750 or Brendan P. O'Hara at (202) 622-7530 (not toll-free calls).

Section 4461.—Harbor Maintenance Tax: Imposition of Tax

Ct.D. 2064

SUPREME COURT
OF THE UNITED STATES

No. 97–372

UNITED STATES v. UNITED STATES SHOE CORP.

523 U.S.____(1998)

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

March 31, 1998

Syllabus

The Harbor Maintenance Tax (HMT) obligates exporters, importers, and domestic shippers, 26 U.S.C. §4461(c)(1), to pay 0.125 percent of the value of the commercial cargo they ship through the Nation's ports, §4461(a). The HMT is imposed at the time of loading for exports and unloading for other shipments. §4461(c)(2). It is collected by the Customs Service and deposited in the Harbor Maintenance Trust Fund (Fund), from which Congress may appropriate amounts to pay for harbor maintenance and development projects and related expenses. §9505. Respondent United States Shoe Corporation (U.S. Shoe) paid the HMT for articles the company exported during the period April to June 1994 and then filed a protest with the Customs Service alleging that, to the extent the toll applies to exports, it violates the Export Clause, U.S. Const., Art. 1, §9, cl. 5, which states: "No Tax or Duty shall be laid on Articles exported from any State." The Customs Service responded to U.S. Shoe with a form letter stating that the HMT is a statutorily mandated user fee, not an unconstitutional tax on exports. U. S. Shoe then sued for a refund, asserting that the HMT violates the Export Clause as applied to exports. In granting U.S. Shoe summary judgment, the Court of International Trade (CIT) held that it had jurisdiction under 28 U.S.C. §1581(i) and that the HMT qualifies as a tax. Rejecting the Government's characterization of the HMT as a user fee, the CIT reasoned that the tax is assessed *ad valorem* directly upon the value of the cargo itself, not upon any services rendered for the cargo. The Federal Circuit affirmed.

Held:

1. The CIT properly entertained jurisdiction in this case. Section 1581(i)(4) gives that court residual jurisdiction over "any civil action . . . against the United States . . . that arises out of any [federal] law . . . providing for . . . administration and enforcement with respect to the matters referred to in [§1581(i)(1)]," which in turn applies to "revenue from imports." This dispute involves such a law. The HMT statute, although applied to exports here, applies equally to imports. That §1581(i) does not use the word "exports" is hardly surprising in view of the Export Clause, which confines customs duties to imports. Moreover, 26 U.S.C. §4462(f)(2) directs that the HMT "be treated as . . . a customs duty" for jurisdictional purposes. Such duties, by their very nature, provide for revenue from imports and are encompassed within §1581(i)(1). Accordingly, CIT jurisdiction over controversies regarding HMT administration and enforcement accords with §1581(i)(4). Pp. 3–5.

2. Although the Export Clause categorically bars Congress from imposing any tax on exports, *United States v. International Business Machines Corp.,* 517 U.S. 843 (*IBM),* it does not rule out a "user fee" that lacks the attributes of a generally applicable tax or duty and is, instead, a charge designed as compensation for government-supplied services, facilities, or benefits, see *Pace v. Burgess,* 92 U.S. 372, 375–376. The HMT, however, is a tax, and thus violates the Export Clause as applied to exports. Pp. 3–9.

(a) The HMT bears the indicia of a tax: Congress expressly described it as such, 26 U. S. C. §4461(a), codified it as part of the Internal Revenue Code, and provided that, for administrative, enforcement, and jurisdictional purposes, it should be

treated "as if [it] were a customs duty," §§4462(f)(1),(2). Prior cases in which this Court upheld flat and ad valorem charges as valid user fees do not govern here because they involved constitutional provisions other than the Export Clause. *IBM* plainly stated that the Export Clause's simple, direct, unqualified prohibition on any taxes or duties distinguishes it from other constitutional limitations on governmental taxing authority. 517 U.S., at 851, 852, 857, 861. Pp. 5–7.

(b) The guiding precedent for determining what constitutes a bona fide user fee in the Export Clause context remains this Court's time-tested *Pace* decision. The *Pace* Court upheld a fee for stamps placed on tobacco packaged for export. The stamp was required to prevent fraud, and the charge for it, the Court said, served as "compensation given for services [in fact] rendered." 92 U.S., at 375. In holding that the fee was not a duty, the Court emphasized that the charge bore no relationship to the quantity or value of the goods stamped for export. *Ibid. Pace* establishes that, under the Export Clause, the connection between a service the Government renders and the compensation it receives for that service must be closer than is present here. Unlike the fee at issue in *Pace,* the HMT *is* determined entirely on an *ad valorem* basis. The value of export cargo, however, does not correlate reliably with the federal harbor services, facilities, and benefits used or usable by the exporter. The Court's holding does not mean that exporters are exempt from any and all user fees designed to defray the cost of harbor development and maintenance. It does mean, however, that such a fee must fairly match the exporters' use of port services and facilities. Pp. 7–9.

114 F. 3d 1564, affirmed.

GINSBURG, J., delivered the opinion for a unanimous Court.

SUPREME COURT
OF THE UNITED STATES

No. 97–372

UNITED STATES, PETITIONER v.
UNITED STATES SHOE
CORPORATION

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT
OF APPEALS FOR THE
FEDERAL CIRCUIT

[March 31, 1998]

JUSTICE GINSBURG delivered the opinion of the Court.

The Export Clause of the Constitution states: "No Tax or Duty shall be laid on Articles exported from any State." U.S. Const., Art. 1, §9, cl. 5. We held in *United States* v. *International Business Machines Corp.*, 517 U.S. 843 (1996) (IBM), that the Export Clause categorically bars Congress from imposing any tax on exports. The Clause, however, does not rule out a "user fee," provided that the fee lacks the attributes of a generally applicable tax or duty and is, instead, a charge designed as compensation for government-supplied services, facilities, or benefits. See *Pace* v. *Burgess*, 92 U.S. 372, 375–376 (1876). This case presents the question whether the Harbor Maintenance Tax (HMT), 26 U.S.C. §4461(a), as applied to goods loaded at United States ports for export, is an impermissible tax on exports or, instead, a legitimate user fee. We hold, in accord with the Federal Circuit, that the tax, which is imposed on an *ad valorem* basis, is not a fair approximation of services, facilities, or benefits furnished to the exporters, and therefore does not qualify as a permissible user fee.

I

The HMT, enacted as part of the Water Resources Development Act of 1986, 26 U.S.C. §§4461–4462, imposes a uniform charge on shipments of commercial cargo through the Nation's ports. The charge is currently set at 0.125 percent of the cargo's value. Exporters, importers, and domestic shippers are liable for the HMT, §4461(c)(1), which is imposed at the time of loading for exports and unloading for other shipments, §4461(c)(2). The HMT is collected by the Customs Service and deposited in the Harbor Maintenance Trust Fund (Fund). Congress may appropriate amounts from the Fund to pay for harbor maintenance and development projects, including costs associated with the St. Lawrence Seaway, or related expenses. §9505.

Respondent United States Shoe Corporation (U.S. Shoe) paid the HMT for articles the company exported during the period April to June 1994 and then filed a protest with the Customs Service alleging the unconstitutionality of the toll to the extent it applies to exports. The Customs Service responded with a form letter stating that the HMT is a statutorily mandated fee assessment on port users, not an unconstitutional tax on exports. On November 3, 1994, U.S. Shoe brought this action against the Government in the Court of International Trade (CIT). The company sought a refund on the ground that the HMT is unconstitutional as applied to exports.

Sitting as a three-judge court, the CIT held that its jurisdiction was properly invoked under 28 U.S.C. §1581(i); on the merits, the CIT agreed with U.S. Shoe that the HMT qualifies as a tax. 907 F. Supp. 408 (1995). Rejecting the Government's characterization of the HMT as a user fee rather than a tax, the CIT reasoned: "The Tax is assessed *ad valorem* directly upon the value of the cargo itself, not upon any services rendered for the cargo. . . . Congress could not have imposed the Tax any closer to exportation, or more immediate to the articles exported." *Id.*, at 418. Relying on the Export Clause, the CIT entered summary judgment for U. S. Shoe.

The Court of Appeals for the Federal Circuit, sitting as a five-judge panel, affirmed. 114F.3d 1564 (1997). On auxiliary questions, the Federal Circuit upheld the CIT's exercise of jurisdiction under §1581(i) and agreed with the lower court that the HMT applied to goods in export transit.[1] Concluding that the HMT is not based on a fair approximation of port use, the Federal Circuit also agreed that the HMT imposes a tax, not a user fee. In making this determination, the Court of Appeals emphasized that the HMT does not depend on the amount or manner of port use, but is determined solely by the value of cargo. Judge Mayer dissented; in his view, Congress properly designed the HMT as a user fee, a toll on shippers that supplies funds not for the general support of government, but exclusively for the facilitation of commercial navigation.

[1]The Government does not here challenge the determination that the HMT applies to goods in export transit.

Numerous cases challenging the constitutionality of the HMT as applied to exports are currently pending in the Court of International Trade and the Court of Federal Claims.[2] We granted certiorari, 522 U.S. __ (1997), to review the Federal Circuit's determination that the HMT violates the Export Clause.

II

As an initial matter, we conclude that the CIT properly entertained jurisdiction in this case. The complaint alleged exclusive original jurisdiction in that tribunal under 28 U.S.C. §1581(a) or, alternatively, §1581(i). App. 26. We agree with the CIT and the Federal Circuit that §1581(i) is the applicable jurisdictional prescription. The key directive is stated in 26 U.S.C. §4462(f)(2), which instructs that for jurisdictional purposes, the HMT "shall be treated as if such tax were a customs duty."

Section 1581(a) surely concerns customs duties. It confers exclusive original jurisdiction on the Court of International Trade in "any civil action commenced to contest the [Customs Service's] denial of a protest." A protest, as indicated in 19 U.S.C. §1514, is an essential prerequisite when one challenges an actual Customs decision. As to the HMT, however, the Federal Circuit correctly noted that protests are not pivotal, for Customs "performs no active role," it undertakes "no analysis [or adjudication]," "issues no directives," "imposes no liabilities"; instead, Customs "merely passively collects" HMT payments. 114 F.3d, at 1569.

Section 1581(i) describes the Court of International Trade's residual jurisdiction over

> "any civil action commenced against the United States . . . that arises out of any law of the United States providing for —
>
> "(1) revenue from imports or tonnage;
>
> . . . . .
>
> "(4) administration and enforcement with respect to the matters referred to in paragraphs (l)–(3) of this subsection. . . ."

This dispute, as the Federal Circuit stated, "involve[s] the 'administration and enforcement' of a law providing for revenue from imports because the HMT statute, although applied to exports here, does apply equally to imports." 114F.3d, at 1571. True, §1581(i) does not use the word "exports." But that is hardly surprising in view of the Export Clause, which confines customs duties to imports. Revenue from imports and revenue from customs duties are thus synonymous in this setting. In short, as the CIT correctly concluded and the Federal Circuit correctly affirmed, "Congress [in §4462(f)(2)] directed [that] the [HMT] be treated as a customs duty for purposes of jurisdiction. Such duties, by their very nature, provide for revenue from imports, and are encompassed within [§]1581(i)(1)." 907 F. Supp., at 421. Accordingly, CIT jurisdiction over controversies regarding the administration and enforcement of the HMT accords with §1581(i)(4).[3]

III

Two Terms ago, in *IBM*, this Court considered the question whether a tax on insurance premiums paid to protect exports against loss violated the Export Clause. Distinguishing case law developed under the Commerce Clause, 517 U.S., at 850–852, and the Import-Export Clause, *id.*, at 857–861, the Court held that the Export Clause allows no room for any federal tax, however generally applicable or nondiscriminatory, on goods in export transit. Before this Court's decision in *IBM*, the Government argued that the HMT, even if characterized as a "tax" rather than a "user fee," should survive constitutional review "because it applies without discrimination to exports, imports and domestic commerce alike." Reply Brief for United States 9, n. 2. Recognizing that *IBM* "rejected an indistinguishable contention," the Government now asserts only that HMT is " 'a permissible user fee,' " *ibid.*, a toll within the tolerance of Export Clause precedent. Adhering to the Court's reasoning in *IBM*, we reject the Government's current position.

The HMT bears the indicia of a tax. Congress expressly described it as "a *tax* on any port use," 26 U.S.C. §4461(a) (emphasis added), and codified the HMT as part of the Internal Revenue Code. In like vein, Congress provided that, for administrative, enforcement, and jurisdictional purposes, the HMT should be treated "as if [it] were a customs duty." §§4462(f)(1), (2). However, "we must regard things rather than names," *Pace* v. *Burgess*, 92 U.S., at 376, in determining whether an imposition on exports ranks as a tax. The crucial question is whether the HMT is a tax on exports in operation as well as nomenclature or whether, despite the label Congress has put on it, the exaction is instead a bona fide user fee.

In arguing that the HMT constitutes a user fee, the Government relies on our decisions in *United States* v. *Sperry Corp.*, 493 U.S. 52 (1989), *Massachusetts* v. *United States*, 435 U.S. 444 (1978), and *Evansville-Vanderburgh Airport Authority Dist.* v. *Delta Airlines, Inc.*, 405 U.S. 707 (1972). In those cases, this Court upheld flat and *ad valorem* charges as valid user fees. See *United States* v. *Sperry Corp.*, 493 U.S., at 62 (1½ percent ad valorem fee applied to awards certified by the Iran-United States Claims Tribunal qualifies as a user fee and is not so excessive as to violate the Takings Clause); *Massachusetts* v. *United States*, 435 U.S., at 463–467 (flat federal registration fee imposed annually on all civil aircraft meets genuine user fee standards and, as applied to state-owned aircraft, does not dishonor State's immunity from federal taxation); *Evansville-Vanderburgh Airport Authority*, 405 U.S., at 717–721 (flat charge for each passenger enplaning, levied for the maintenance of State's airport facilities, does not run afoul of the dormant Commerce Clause). Those decisions involved constitutional provisions other than the Export Clause, however, and thus do not govern here.

IBM plainly stated that the Export Clause's simple, direct, unqualified prohibition on any taxes or duties distinguishes

[2] According to the Government, some 4,000 cases raising this claim are currently stayed in the CIT, with more than 100 additional cases stayed in the Court of Federal Claims. See Brief for United States 4.

[3] Because we determine that the Court of International Trade has exclusive jurisdiction over challenges to the HMT under §1581(i)(4), it follows that the Court of Federal Claims lacks jurisdiction over the challenges to the HMT currently pending there. See 28 U.S.C. §1491(b). The plaintiffs in these challenges may invoke §1631, which authorizes intercourt transfers, when "in the interest of justice," to cure want of jurisdiction. See also §610 (as used in Title 28, the term "court" includes the Court of Federal Claims and the CIT).

it from other constitutional limitations on governmental taxing authority. The Court there emphasized that the "text of the Export Clause . . . expressly prohibits Congress from laying any tax or duty on exports." 517 U.S., at 852; see also *id.,* at 861 ("[T]he Framers sought to alleviate . . . concerns [that Northern States would tax exports to the disadvantage of Southern States] by completely denying to Congress the power to tax exports at all."). Accordingly, the Court reasoned in *IBM,* "[o]ur decades-long struggle over the meaning of the nontextual negative command of the dormant Commerce Clause does not lead to the conclusion that our interpretation of the textual command of the Export Clause is equally fluid." *Id.,* at 851; see also *id.,* at 857 ("We have good reason to hesitate before adopting the analysis of our recent Import-Export Clause cases into our Export Clause jurisprudence. . . . [M]eaningful textual differences exist [between the two Clauses] and should not be overlooked."). In *Sperry,* moreover, we noted that the Takings Clause imposes fewer constraints on user fees than does the dormant Commerce Clause. See 493 U.S., at 61, n. 7 (analysis under Takings Clause is less "exacting" than under the dormant Commerce Clause). *A fortiori,* therefore, the Takings Clause is less restrictive than the Export Clause.

The guiding precedent for determining what constitutes a bona fide user fee in the Export Clause context remains our time-tested decision in *Pace*. *Pace* involved a federal excise tax on tobacco. Congress provided that the tax would not apply to tobacco intended for export. To prevent fraud, however, Congress required that tobacco the manufacturer planned to export carry a stamp indicating that intention. Each stamp cost 25 cents (later 10 cents) per package of tobacco. Congress did not limit the quantity or value of the tobacco packaged for export or the size of the stamped package; "[t]hese were unlimited, except by the description of the exporter or the convenience of handling." 92 U.S., at 375.

The Court upheld the charge, concluding that it was "in no sense a duty on exportation," but rather "compensation given for services [in fact] rendered." *Ibid.* In so ruling, the Court emphasized two characteristics of the charge: It "bore no proportion whatever to the quantity or value of the package on which [the stamp] was affixed"; and the fee was not excessive, taking into account the cost of arrangements needed both "to give to the exporter the benefit of exemption from taxation, and . . . to secure . . . against the perpetration of fraud." *Ibid.*

Pace establishes that, under the Export Clause, the connection between a service the Government renders and the compensation it receives for that service must be closer than is present here. Unlike the stamp charge in *Pace,* the HMT is determined entirely on an *ad valorem* basis. The value of export cargo, however, does not correlate reliably with the federal harbor services used or usable by the exporter. As the Federal Circuit noted, the extent and manner of port use depend on factors such as the size and tonnage of a vessel, the length of time it spends in port, and the services it requires, for instance, harbor dredging. See 114 F. 3d, at 1572.

In sum, if we are "to guard against . . . the imposition of a [tax] under the pretext of fixing a fee," *Pace* v. *Burgess,* 92 U.S., at 376, and resist erosion of the Court's decision in *IBM,* we must hold that the HMT violates the Export Clause as applied to exports. This does not mean that exporters are exempt from any and all user fees designed to defray the cost of harbor development and maintenance. It does mean, however, that such a fee must fairly match the exporters' use of port services and facilities.

* * *

For the foregoing reasons, the judgment of the Court of Appeals for the Federal Circuit is

Affirmed.

Designated Private Delivery Services

Notice 98–47

This notice updates the list of private delivery services ("PDSs") designated under Notice 97–26, 1997–1 C.B. 413, and Notice 97–50, 1997–37 I.R.B. 21 ("designated PDSs") for purposes of the "timely mailing as timely filing/paying" rule of § 7502 of the Internal Revenue Code, effective September 1, 1998.

Section 7502(f) authorizes the Secretary to designate certain PDSs for the "timely mailing as timely filing/paying" rule of § 7502. Rev. Proc. 97–19, 1997–1 C.B. 644, provides the criteria currently applicable for designation of a PDS. Notice 97–50, modifying Notice 97–26 and Rev. Proc. 97–19, provides that each year there will be only one application period, which will end on June 30th. Notice 97–50 also provides that the Service will issue a notice providing a new list of designated PDSs on or before September 1st of each year for which Rev. Proc. 97–19 is in effect.

Effective September 1, 1998, the list of designated PDSs is as follows:

1. Airborne Express (Airborne): Overnight Air Express Service, Next Afternoon Service, and Second Day Service;
2. DHL Worldwide Express (DHL): DHL "Same Day" Service and DHL USA Overnight;
3. Federal Express (FedEx): FedEx Priority Overnight, FedEx Standard Overnight, and FedEx 2 Day; and
4. United Parcel Service (UPS): UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, and UPS 2nd Day Air A.M.

This list remains unchanged from the lists published in Notice 97–26 and Notice 97–50. Airborne, DHL, FedEx, and UPS are not designated with respect to any type of delivery service not identified above. Notice 97–26 also provides special rules used to determine the date that will be treated as the postmark date for purposes of § 7502.

EFFECT ON OTHER DOCUMENTS

Notice 97–50 is modified by updating the list of designated PDSs.

EFFECTIVE DATE

This notice is effective on September 1, 1998.

FOR FURTHER INFORMATION

The principal author of this notice is Renay France of the Office of the Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this notice, contact Ms. France at (202) 622-6232 (not a toll-free call).

Section 198: Expensing of environmental remediation costs.

Rev. Proc. 98–47

SECTION 1. PURPOSE

This revenue procedure provides procedures for taxpayers to make the election under § 198 of the Code ("§ 198 election") to deduct any qualified environmental remediation expenditure ("QER expenditure").

SECTION 2. BACKGROUND

.01 Section 198(a), as added by § 941(a) of the Taxpayer Relief Act of 1997, Pub. L. No. 105–34, 111 Stat. 788 (Aug. 5, 1997), provides that a taxpayer may elect to treat any QER expenditure as an expense that is not chargeable to the capital account, but is deductible for the taxable year in which it is paid or incurred.

.02 Section 198(b)(1) generally defines a "qualified environmental remediation expenditure" as any expenditure that is otherwise chargeable to the capital account, and that is paid or incurred in connection with the abatement or control of hazardous substances as a qualified contaminated site. However, under § 198(b)(2) a QER expenditure does not include any expenditure for property subject to an allowance for depreciation, except that the portion of the allowance for depreciation of such property that is otherwise allocated to a qualified contaminated site is treated as a QER expenditure.

.03 Section 198(c)(1)(A) defines a "qualified contaminated site" as any area:

(i) that is held by the taxpayer for use in a trade or business or for the production of income, or that is property described in § 1221(1) in the hands of the taxpayer;

(ii) that is within a targeted area (as defined in § 198(c)(2)); and

(iii) at or on which there has been a release (or threat of release) or disposal of any hazardous substance.

Section 198(c)(1)(B) provides that an area is treated as a qualified contaminated site with respect to expenditures paid or incurred during any taxable year only if the taxpayer receives a statement from an appropriate agency of the state (as defined by § 198(c)(1)(C)) in which the area is located, verifying that the area meets the requirements of § 198(c)(1)(A)(ii) and (iii) (described above).

.04 Section 198(d)(1) generally defines "hazardous substance" as any substance that is a hazardous substance as defined in § 101(14) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA), and any substance that is designated as a hazardous substance under § 102 of CERCLA.

.05 Section 198 is effective for expenditures paid or incurred after August 5, 1997, and on or before December 31, 2000. *See* § 198(h).

SECTION 3. PROCEDURE

.01 *Time for Making the Election.*

Except as provided in section 3.02(3) of this revenue procedure, a § 198 election must be made on or before the due date (including extensions) for filing the income tax return for the taxable year in which the QER expenditures are paid or incurred.

.02 *Manner of Making the Election.*

(1) *Individuals.* Individuals must include the total amount of § 198 expenses on the line for "Other Expenses" on Schedule C, E, or F (as appropriate) for Form 1040, U.S. Individual Income Tax Return. Wherever the schedule requires that the taxpayer separately identify each expense included in "Other Expenses," the taxpayer must write "Section 198 Election" on the line on which the § 198 expense amounts separately appear.

(2) *All other entities.* Persons other than individuals (including S corporations, partnerships, and trusts) must include the total amount of § 198 expenses

on the line for "Other Deductions" (or the equivalent thereof) on their appropriate federal income tax return. On a schedule attached to the return that separately identifies each expense included in "Other Deductions" (or the equivalent thereof), the taxpayer must write "Section 198 Election" on the line on which the § 198 expense amounts separately appear.

(3) *Transition rule.* Taxpayers that claim a deduction for QER expenditures, paid or incurred after August 5, 1997, on a return filed on or before October 14, 1998, will be deemed to have made a § 198 election with respect to those expenditures, even if no reference to § 198 is contained on the return. If a taxpayer did not claim a deduction for such QER expenditures on such return, the taxpayer may make the § 198 election for those expenditures for the taxable year covered by the return only by filing an amended return (within the applicable period of limitations) that complies with section 3.02(1) and (2) of this revenue procedure.

.03 *Scope of Election.*

If, for any taxable year, the taxpayer pays or incurs more than one QER expenditure, the taxpayer may make a § 198 election for any one or more of such expenditures for that year. Thus, the taxpayer may make a § 198 election with respect to a QER expenditure even though the taxpayer chooses to capitalize other such expenditures (whether or not they are of the same type or paid or incurred with respect to the same qualified contaminated site). A § 198 election for one year has no effect for other years. Thus, a taxpayer must make a § 198 election for each year in which the taxpayer intends to deduct QER expenditures.

.04 *Revocation.*

A § 198 election is revocable only with the prior written consent of the Commissioner. To obtain the Commissioner's consent, a taxpayer must submit a request for a private letter ruling in accordance with the provisions of Rev. Proc. 98–1, 1998–1 I.R.B. 7 (or its successor). The taxpayer may submit a request for revocation for any taxable year for which the period of limitations for filing a claim for credit or refund of overpayment of tax has not expired.

SECTION 4. EFFECTIVE DATE

This revenue procedure is effective for QER expenditures paid or incurred after August 5, 1997.

DRAFTING INFORMATION

The principal author of this revenue procedure is J. Peter Baumgarten of the office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Baumgarten on (202) 622-4950 (not a toll-free call).

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26 CFR 601.602: Forms and instructions.
(Also Part I, sections 446, 471, 472, 1.446–1, 1.471–8, 1.472–1.)

Rev. Proc. 98–49

SECTION 1. PURPOSE

This revenue procedure provides guidance to taxpayers that use the dollar-value last-in, first-out (LIFO) inventory method and the inventory price index computation (IPIC) method regarding the computation of a percent change for the first taxable year in which such percent change is computed with reference to a revised *CPI Detailed Report* (CPI) or a *PPI Detailed Report* (PPI) for any index category affected by such revisions. A revised CPI or PPI is one that contains new index categories, eliminates some previously reported index categories, resets the base year of some index categories, or does not report the relative weights of some index categories. Generally, under this revenue procedure, any reasonable method of computing a percent change for a selected index category affected by revisions to the CPI or PPI will be accepted by the Internal Revenue Service. This revenue procedure also provides a specific safe harbor method that will be considered a reasonable method for these purposes.

SECTION 2. BACKGROUND

.01 Section 472(a) of the Internal Revenue Code authorizes a taxpayer to use the LIFO inventory method in accordance with regulations prescribed by the Secretary.

.02 Section 1.472–8(a) of the Income Tax Regulations provides that a taxpayer may elect to determine the cost of its LIFO inventories under the dollar-value LIFO method, provided that method is used consistently and clearly reflects the taxpayer's income.

.03 Section 1.472–8(e)(1) authorizes three methods for computing the LIFO value of a dollar-value inventory pool: (1) the double-extension method, (2) an index method, and (3) the link-chain method.

.04 Section 1.472–8(e)(3)(i) authorizes the use of the IPIC method to compute the LIFO value of a dollar-value inventory pool. An inventory price index computed in the manner provided in § 1.472–8(e)(3) will be accepted by the Commissioner as an appropriate method of computing an index, and the use of such index will be accepted as accurate, reliable, and suitable.

.05 Section 1.472–8(e)(3)(ii) provides that an inventory price index computed under the IPIC method must be a stated percentage of the percent change in the selected consumer or producer price index or indexes. The stated percentage for a taxpayer in a taxable year in which it is an eligible small business is 100 percent of the percent change in the selected price indexes. The stated percentage for all other taxpayers is 80 percent of the percent change in the selected price indexes. If it is necessary to select more than one specific consumer or producer price index for an inventory pool, the stated percentage of the percent change is the stated percentage of the weighted average percent change for such indexes. Such weighed average is computed by reference to the relative amounts of current-year costs in the inventory pool for each index category of goods.

.06 Section 1.472–8(e)(3)(iii) describes the process for selecting consumer and producer price indexes under the IPIC method. Inventory items in each of the taxpayer's pools are classified according to the detailed listings in the appropriate tables of the CPI or PPI (formerly known as *Producer Prices and Price Indexes*) and assigned to various index categories. § 1.472–8(e)(3)(iii)(B). Indexes and weights published by the United States Bureau of Labor Statistics (BLS) are used to compute the percent change for each index category to which inventory items have been assigned. *Id.* In many cases, the selected index for an index category must be converted into a cost price index prior to the computation of the percent change for the index category. § 1.472–8(e)(3)(iii)(C). In the case of a taxpayer

using the retail inventory method, the index selected must be the index as of the last month of the taxpayer's taxable year. *Id.* Taxpayers that do not use the retail method must select indexes as of the month or months most appropriate to the taxpayer's method of determining the current-year cost of the inventory pool under § 1.472–8(e)(2)(ii), or make a one-time binding election of an appropriate representative month during the taxable year. *Id.*

.07 The BLS frequently makes changes to the categories included in the CPI or PPI. For example, the BLS revised the categories of goods listed in the January 1998 CPI by introducing some new categories as of January 1998 and eliminating or resetting some existing categories as of December 1997. Consequently, January 1999 will be the first month for which it is possible to compute a percent change for a 12-month period with reference to the BLS published indexes for any affected index category (as described in section 3 of this revenue procedure). Moreover, the BLS did not publish weights for some index categories.

SECTION 3. SCOPE

This revenue procedure applies to a taxpayer that uses the dollar-value LIFO inventory and IPIC methods pursuant to § 1.472–8(e)(3) for any taxable year in which a percent change for an index category for the 12-month period ending with the appropriate index month, as defined in § 1.472–8(e)(iii)(C) ("index month"), (or, in the case of a short taxable year, the applicable period) cannot be computed by the taxpayer in strict conformity with § 1.472–8(e)(3)(ii) or (iii) because of revisions to the CPI or PPI as described in section 2.07 of this revenue procedure ("affected index category").

SECTION 4. APPLICATION

A taxpayer described in section 3 of this revenue procedure may use any reasonable method of computing a percent change for each affected index category, provided such method is used consistently for all affected index categories within a particular taxable year. The procedure for computing a percent change for an affected index category set forth in section 5 of this revenue procedure is deemed to be a reasonable method for these purposes.

SECTION 5. PROCEDURE

.01 When a revised CPI or PPI includes new index categories or eliminates or resets old index categories, a taxpayer may compute a total percent change for each affected index category represented in the taxpayer's ending inventory in accordance with the procedure provided in this section 5.01. This total percent change will be a combination of the percent change for the second portion of the taxable year based on the revised index category and the corresponding percent change for the first portion of the taxable year based on the old index category.

(1) A taxpayer must first compute the percent change for each affected index category set forth in the revised CPI or PPI for the period between the first month covered by the revised CPI or PPI and the index month ("the second portion") as follows:

(a) Using the appropriate table of the revised CPI or PPI for the index month, all specific inventory items must be placed in the most detailed index category that includes that specific inventory item (without regard to the index selection requirements in § 1.472–8(e)(3)-(iii)(B)).

(b) The percent change of each revised CPI or PPI index category for the second portion is determined using the following formula:

[(A-B) / B) * 100]

where:

A = Cumulative index for index month (adjusted, as necessary, to reflect a cost or retail price index)

B = Cumulative index for last month of old CPI or PPI as published for the first month of revised CPI or PPI (adjusted, as necessary, to reflect a cost or retail price index).

(2) A taxpayer must then compute a percent change for each affected index category set forth in the old CPI or PPI for the period between the preceding year's index month and the last month covered by the old CPI or PPI ("the first portion") as follows:

(a) Using the appropriate table of the old CPI or PPI for the preceding year's index month, all specific inventory items must be placed in the most detailed index category that includes that specific inventory item (without regard to the index selection requirements of § 1.472–8(e)(3)(iii)(B)).

(b) The percent change of each old CPI or PPI index category for the first portion is determined using the following formula:

[(C–D) / D) * 100]

where:

C = Cumulative index for last month of old CPI or PPI as published for the last month of old CPI or PPI (adjusted, as necessary, to reflect a cost or retail price index)

D = Cumulative index for preceding year's index month (adjusted, as necessary, to reflect a cost or retail price index).

(3) The taxpayer will then determine the total percent change for each index category set forth in the revised CPI or PPI represented in the ending inventory by combining the percent change for the second portion with the corresponding percent change for the first portion using the following formula:

({[(X + 100) * (Y + 100)] / 100} – 100)

where:

X = Percent change for the second portion

Y = Percent change for the first portion.

For purposes of computing the total percent change for each revised CPI or PPI index category, the corresponding percent change for the first portion is the percent change for the old CPI or PPI index category that includes the specific inventory item(s) included in the revised CPI or PPI index category. If specific inventory items included in a single revised CPI or PPI index category were separately included in different old CPI or PPI index categories, the corresponding percent change for the first portion is the weighted average percent change of such old CPI or PPI percent changes. The costs to be used in computing such weighted average must be the relative current-year costs in ending inventory.

.02 When § 1.472–8(e)(3)(iii)(B)(5) requires a taxpayer to compute a percent change for a selected index category using the BLS weights and the CPI or PPI does not report the relative weights for one or more of the taxpayer's detailed

index categories within a selected index category, the taxpayer may weight the detailed index categories actually present in its ending inventory within such selected index category using the taxpayer's actual inventory weights.

SECTION 6. EXAMPLE

.01 The following example illustrates the index selection and computation procedure described in section 5 of this revenue procedure. *X*, a retailer, uses the retail inventory method along with the dollar-value LIFO and IPIC inventory methods and files its returns on the basis of a taxable year ending on January 31. Under § 1.472–8(e)(3)(iii)(C), *X* is required to select indexes from the CPI as of January, the last month of *X*'s taxable year. *X* has five items in its only dollar-value LIFO pool on January 31, 1998—tomatoes, bananas, lemons, oranges, and peaches. The retail selling prices of the goods were tomatoes, $1,000; bananas, $80; lemons, $50; oranges, $50; and peaches, $20.

.02 Pursuant to § 1.472–8(e)(3)(iii)(B), *X* assigns the items to the most detailed listings in the January 1998 CPI as follows: tomatoes are assigned to "Tomatoes;" bananas are assigned to "Bananas;" lemons are assigned to "Citrus fruits;" oranges are assigned to "Oranges, including tangerines;" and peaches are assigned to "Other fresh fruits."

.03 *X* selects the index for "Tomatoes" because tomatoes represent more than 10% of its total inventory value. §§ 1.472–8(e)(3)(iii)(B)(1) and (4). *X* can compute a total percent change for "Tomatoes" in accordance with §§ 1.472–8(e)(3)(ii) and (iii) using the information contained in the CPI for January 1997 and January 1998. Thus, the "Tomatoes" index category is not an affected index category, and *X* must compute the total percent change for that index category in accordance with §§ 1.472–8(e)(3)(ii) and (iii). Because no remaining detailed index category contains 10% or more of *X*'s total inventory value, *X* must investigate successively less detailed index category levels. § 1.472–8(e)(3)(iii)(B)(2). *X* discovers that the remainder of its inventory fits within the "Fresh fruits" index category. *X*, however, may not use the published "Fresh fruits" index for the remainder of its goods, because *X*'s inventory does not include apples. § 1.472–8(e)(3)(iii)(B)(5). *X* must compute a percent change for the "Fresh fruits" index category using the BLS indexes and weights published for the detailed index categories actually present in its inventory. *Id.* However, the BLS did not publish a cumulative index for "Citrus fruits" in the January 1997 CPI or weights for "Oranges, including tangerines" in the January 1998 CPI. Moreover, the BLS reset the base year for "Other fresh fruits" in the January 1998 CPI. Since *X* cannot compute a total percent change for "Fresh fruits" in strict conformity with §§ 1.472-8(e)(3)(ii) and (iii), *X* chooses to compute such total percent change using the method described in section 5 of this revenue procedure.

.04 Pursuant to section 5.01(1)(a) of this revenue procedure, *X* assigns the inventory items within the affected "Fresh fruits" category to the most detailed index categories in the 1998 CPI as follows: bananas are assigned to "Bananas;" lemons are assigned to "Citrus fruits;" oranges are assigned to "Oranges, including tangerines;" and peaches are assigned to "Other fresh fruits." Pursuant to section 5.01(1)(b) of this revenue procedure, *X* computes the percent changes for the second portion as follows:

Items	1998 Category		Computation				% Change
bananas	Bananas	=	[(154.7 – 151.5) / 151.5)]	*	100	=	2.1122
lemons	Citrus f	=	[(105.6 – 100.0) / 100.0)]	*	100	=	5.6000
oranges	Oranges	=	[(201.3 – 189.3) / 189.3)]	*	100	=	6.3391
peaches	Other ff	=	[(96.6 – 100.0) / 100.0)]	*	100	=	–3.4000

.05 Pursuant to section 5.01(2)(a) of this revenue procedure, *X* assigns the items to the most detailed index categories in the January 1997 CPI as follows: bananas are assigned to "Bananas;" lemons are assigned to "Other fresh fruits;" oranges are assigned to "Oranges, including tangerines;" and peaches are assigned to "Other fresh fruits." Pursuant to section 5.01(2)(b) of this revenue procedure, *X* computes the percent changes for the first portion as follows:

Items	1997 Category		Computation				% Change
bananas	Bananas	=	[(151.5 – 161.9) / 161.9)]	*	100	=	–6.4237
lemons	Other ff	=	[(294.9 – 290.2) / 290.2)]	*	100	=	1.6196
oranges	Oranges	=	[(189.3 – 187.4) / 187.4)]	*	100	=	1.0139
peaches	Other ff	=	[(294.9 – 290.2) / 290.2)]	*	100	=	1.6196

.06 Pursuant to section 5.01(3) of this revenue procedure, *X* computes the total percent change for each 1998 CPI detailed index category by combining the corresponding percent changes for the first and second portions as follows:

1998 Category		Computation				% Change
Bananas	=	{[(102.1122	*	93.5763) / 100] – 100}	=	–4.4472
Citrus f	=	{[(105.6000	*	101.6196) / 100] – 100}	=	7.3103
Oranges	=	{[(106.3391	*	101.0139) / 100] – 100}	=	7.4173
Other ff	=	{[(96.6000	*	101.6196) / 100] – 100}	=	–1.8355

Because the BLS published the total percent change for "Bananas" and "Oranges, including tangerines" in the January 1998 CPI, it was not necessary for *X* to compute a total percent change for those detailed index categories pursuant to section 5.01 of this revenue procedure.

.07 Pursuant to section 5.02 of this revenue procedure, *X* computes the weights for each 1998 CPI detailed index category as follows:

1998 Detailed Category		Detailed Category Cost		Selected Category Cost		Weight
Bananas	=	$80	/	$200	=	0.40
Citrus fruits	=	$50	/	$200	=	0.25
Oranges	=	$50	/	$200	=	0.25
Other fresh fruits	=	$20	/	$200	=	0.10

Then, *X* weights the percent change for each 1998 CPI detailed index category and adds them together to determine the total percent change for the "Fresh fruits" index category as follows:

1998 Detailed Category		Weight		% Change		Weighted % Change
Bananas	=	0.40	×	–4.4472	=	–1.7789
Citrus fruits	=	0.25	×	7.3103	=	1.8276
Oranges	=	0.25	×	7.4173	=	1.8543
Other fresh fruits	=	0.10	×	–1.8355	=	–0.1836
Total Percent Change						+1.7194

SECTION 7. METHOD OF ACCOUNTING

The selection of a new consumer or producer price index for a specific inventory item to compute an inventory price index as a result of revisions to the CPI or PPI as described in section 2.07 of this revenue procedure will not be treated as a change in method of accounting. Any other change in the selection of a consumer or producer price index for a specific inventory item is a change in method of accounting for which the taxpayer must secure the consent of the Commissioner as provided in § 446(e). *See* § 1.472–8(e)(3)(iii)(B).

DRAFTING INFORMATION

The principal author of this revenue procedure is Jeffery G. Mitchell of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Mitchell on (202) 622-4970 (not a toll free call).

26 CFR 601.602: Tax forms and instructions.

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PART A. GENERAL

SEC. 1. PURPOSE

.01 Form 8027 is used by large food or beverage establishments when the employer is required to make annual reports to the IRS on receipts from food or beverage operations and tips reported by employees.

☞ **Note: All employees receiving $20.00 or more a month in tips must report 100% of their tips to their employer**

.02 The Internal Revenue Service Martinsburg Computing Center (IRS/MCC) has the responsibility of processing Forms 8027 submitted magnetically/electronically. The purpose of this revenue procedure is to provide the specifications for filing Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips, magnetically or electronically. This revenue procedure is updated when legislative changes occur or reporting procedures are modified. Major changes have been emphasized by italics.

.03 This revenue procedure supersedes the following: Rev. Proc. 92–81 published as Publication 1239 (9–92), Specifications for Filing Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips, on Magnetic Tape and 5 ¼ or 3 ½ inch Magnetic Diskettes.

SEC. 2. NATURE OF CHANGES

.01 Numerous editorial changes have been made to the revenue procedure. Please read the publication carefully and in its entirety before attempting to prepare your magnetic media for submission. The changes are as follows:

(a) The title of Publication 1239 has changed from "Specifications for Filing Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips, on Magnetic Tape and 5 ¼ or 3 ½-Inch Magnetic Diskettes" to "Specifications for Filing Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips Magnetically/Electronically."

(b) Updated information on IRS/MCC's mailing addresses, telephone numbers and the Call Site are provided in Part A, Sec. 3.

(c) A note regarding denial of waivers in Part A, Section 5.06 was deleted. While IRS/MCC encourages filers to request waivers at least 45 days prior to the due date of the return, we **will accept** waivers postmarked by the due date of the return.

(d) Part A, Section 10, Extensions of Time To File, has been completely revised. Form 8809, Request for Extension of Time To File Information Returns, should be submitted to request an extension of time to file Form 8027.

.02 Starting with tax year 1997 returns, IRS/MCC will accept Forms 8027 via the following additional options:

(a) Tape cartridge specifications are in Part B, Sec. 4.

(b) 8mm, 4mm, quarter inch cartridges specifications are in Part B, Sec. 5.

(c) Asynchronous electronic filing specifications through the Information Reporting Program-Bulletin Board (IRP-BBS) are in Part B, Sec. 6.

.03 Form 5064 media label has been obsoleted. Filers can now prepare their own self-sticking label. Notice 210 details what information should be included on the label.

.04 A page of cut out labels has been included for filers to use in mailing their media to MCC. A label should be affixed to the outside of the package to help expedite handling.

.05 Part B, Section 7 is now titled Record Format and Layout. A record layout now follows the record format specifications.

SEC. 3. WHERE TO FILE AND HOW TO CONTACT THE IRS MARTINSBURG COMPUTING CENTER

.01 All Forms 8027 filed magnetically or electronically are processed at IRS/MCC and are to be sent to the following addresses:

If by Postal Service:
IRS-Martinsburg Computing Center
Information Reporting Program
P. O. Box 1359
Martinsburg, WV *25402-1359*

or

If by truck or air freight:
IRS-Martinsburg Computing Center
Information Reporting Program
Route 9 and Needy Road
Martinsburg, WV 25401

Note: The ZIP Code has changed from 25401-1359 to 25402-1359 for the IRS P.O. Box address for Martinsburg, WV.

.02 Publication 1239 and other IRS publications concerning magnetic/electronic filing of information returns are available through the IRP-BBS as "downloadable" files. Using IRP-BBS as a means of obtaining publications will provide faster access to this information. Additionally, publications will be available from IRP-BBS much earlier than the printed version. The IRP-BBS is operational 24 hours a day, 7 days a week. *The telephone number is (304)264-7070.*

.03 Requests for paper forms and publications should be requested by calling the "Forms Only Number" listed in your local telephone directory or by calling the IRS toll-free number **1-800-TAX- FORM (1-800-829-3676).**

.04 Questions pertaining to magnetic media filing of Forms W-2 **must** be directed to the Social Security Administration (SSA). Filers can call 1-800-SSA-1213 to obtain the phone number of the SSA Magnetic Media Coordinator for their area.

.05 A taxpayer or authorized representative may request a copy of a tax return or a Form W-2 filed with a return by submitting Form 4506, Request for Copy or Transcript of Tax Form, to IRS. This form may be obtained by calling ***1-800-TAX-FORM (1-800-829-3676).***

.06 The IRS/MCC Call Site, located in Martinsburg, WV, provides service to the payer/employer community (financial institutions, employers, and other transmitters of information returns). The IRS/MCC Call Site answers questions concerning tax law and magnetic/electronic filing of Forms 8027 and other information returns (Forms 1096, 1098, 1099, 5498, W-2G, W-3, 1042-S), questionable Forms W-4, inquiries dealing with backup withholding due to missing and incorrect taxpayer identification numbers and questions concerning paper filing of Forms W-2. Recipients of information returns (payees) should continue to contact 1-800-829-1040 or other numbers specified in the tax return instructions with any questions on how to report tax returns.

The Call Site accepts calls from all areas of the country. The number to call is ***304-263-8700*** *or Telecommunications Device for the Deaf* ***(TDD) 304-267-3367.*** *These are toll calls. Hours of operation for the Call Site are Monday through Friday, 8:30 a.m. to 4:30 p.m. Eastern Time. The Call Site is in operation throughout the year to handle the questions of payers, transmitters, and employers. Due to the high demand for assistance at the end of January and February, it is advisable to call as soon as possible to avoid these peak filing seasons.*

.07 The telephone numbers for magnetic media inquiries or electronic submissions are:

304-263-8700 – Call Site
304-264-7070 **– IRP-BBS (Information Reporting Program-Bulletin Board System)**
304-267-3367 – TDD (Telecommunication Device for the Deaf)
304-264-5602 – Fax Machine
(These are not toll-free telephone numbers.)

SEC. 4. FILING REQUIREMENTS

.01 Section 6011(e)(2)(A) of the Internal Revenue Code requires that any person, including corporations, partnerships, individuals, estates, and trusts, required to file 250 or more information returns must file such returns on magnetic media.

.02 The filing requirements apply separately to both original and corrected returns.

.03 Filing electronically through the Information Reporting Program-Bulletin Board System (IRP-BBS) fulfills the magnetic media filing requirement.

.04 The above requirements do not apply if you establish undue hardship (see Part A, Sec. 5).

SEC. 5. REQUEST FOR WAIVER FROM FILING INFORMATION RETURNS ON MAGNETIC MEDIA

.01 If an employer is required to file on magnetic media but fails to do so (or fails to file electronically, in lieu of magnetic media filing) and does not have an approved waiver on record, the employer will be subject to a penalty of $50 per return in excess of 250.

.02 If employers are required to file original or corrected returns on magnetic media, but such filing would create a hardship, they may request a waiver from these filing requirements by submitting Form 8508, Request for Waiver From Filing Information Returns on Magnetic Media, to IRS/MCC.

.03 Even though an employer may submit as many as 250 corrections on paper, IRS encourages magnetically or electronically submitted corrections. Once the 250 threshold has been met, filers are required to submit any additional returns magnetically or electronically. However, if a waiver for an original filing is approved, any corrections for the same type of returns will be covered under this waiver.

.04 Generally, only the employer may sign the Form 8508. A transmitter may sign if given power of attorney; however, a letter signed by the employer stating this fact must be attached to the Form 8508.

.05 A transmitter must submit a separate Form 8508 for each employer. Do not submit a list of employers.

.06 All information requested on the Form 8508 must be provided to IRS for the request to be processed.

.07 The waiver, if approved, will provide exemption from magnetic media filing for the current tax year only. Employers may not apply for a waiver for more than one tax year at a time; application must be made each year a waiver is necessary.

.08 Form 8508 may be photocopied or computer-generated as long as it contains all the information requested on the original form.

.09 Filers are encouraged to submit Form 8508 to IRS/MCC at least 45 days before the due date of the returns.

.10 **File Form 8508 for Forms W–2 with IRS/MCC, not SSA.**

.11 Waivers are evaluated on a case-by-case basis and are approved or denied based on criteria set forth under section 6011(e) of the Internal Revenue Code. The transmitter must allow a minimum of 30 days for IRS/MCC to respond to a waiver request.

.12 If a waiver request is approved, the transmitter should keep the approval letter on file. **The transmitter should not send a copy of the approved waiver to the service center where the paper returns are filed.**

.13 An approved waiver from filing information returns on magnetic media does not provide exemption from all filing. The employer must timely file information returns on acceptable paper forms with the appropriate service center.

SEC. 6. APPLICATION FOR MAGNETIC/ELECTRONIC REPORTING

.01 For the purposes of this revenue procedure, the EMPLOYER is the organization supplying the information and the TRANSMITTER is the organization preparing the magnetic/electronic file and/or sending the file to IRS/MCC. The employer and the transmitter may be the same entity. Employers or their transmitters are required to complete Form 4419, Application for Filing Information Returns Magnetically/Electronically.

.02 Form 4419 can be submitted at any time during the year; however, it should be submitted to IRS/MCC at least 30 days before the due date of the return(s). IRS will act on an application and notify the applicant, in writing, of authorization to file. A five-character alpha/numeric Transmitter Control Code (TCC) will be assigned and included in an acknowledgment letter within 15 to 45 days of receipt of the application. Magnetic/electronic returns may not be filed with IRS until the application has been approved and a TCC assigned. Include your TCC in any correspondence with IRS/MCC.

.03 If you file information returns other than Form 8027 on magnetic media, you must obtain a separate TCC for those types of returns. The TCC assigned for Forms 8027 is to be used for the processing of those forms only.

.04 Upon approval, a magnetic media reporting package containing the current revenue procedure, forms, and instructions will be sent to the attention of the contact person indicated on Form 4419. Thereafter, IRS/MCC will send the transmitter a package containing the current revenue procedure and forms each year. This package will continue to be sent to the contact person indicated on the Form 4419 unless IRS/MCC has been notified in writing of any changes or updates. After you have received approval to file on magnetically/electronically, you do not need to reapply each year; however, notify IRS in writing if:

(a) You change your name or the name of your organization, so that your files may be updated to reflect the proper name;

(b) You discontinue filing on magnetic media for two years (your TCC may have been reassigned).

.05 If you plan to file for multiple employers, IRS encourages transmitters to submit one application and to use one TCC for all employers.

.06 Only employers or transmitters using equipment compatible with IRS equipment will have their application approved.

.07 If your magnetic media files have been prepared for you in the past by a transmitter, and you now have computer equipment compatible with that of IRS and wish to prepare your own files, you must request your own five-character alpha/numeric TCC by filing an application, Form 4419, as described in Sec. 6.02.

SEC. 7. TEST FILES

.01 IRS/MCC encourages new filers to submit test files for review in advance of the filing season. Employers or transmitters must be approved to file magnetically/electronically before a test file is submitted (See Part A, Sec. 6 for application procedures.)

.02 All test files must be submitted between October 1 and December 15 of the year before the returns are due. If you are unable to submit your test files by December 15, you may send a sample hard copy printout to IRS/MCC between December 16 and January 15. Clearly mark the hardcopy printout as "TEST DATA" and include the name, address, and telephone number of someone familiar with the test printout who may be contacted to discuss its acceptability.

SEC. 8. FILING OF FORM 8027 MAGNETICALLY/ELECTRONICALLY

.01 Form 4804, Transmittal of Information Returns Reported Magnetically/Electronically, must accompany **all** magnetic media shipments. If you file for multiple employers and have the authority to sign the affidavit on Form 4804, you should also submit Form 4802, Transmittal of Information Returns Reported Magnetically/Electronically (Continuation). *For electronic transmissions, the Form 4804 and Form 4802, if applicable, must be sent the same day as the electronic transmission.*

.02 The employer **MUST** sign Form 4804, however, an agent (transmitter, service bureau, paying agent, or disbursing agent) may sign Form 4804 for the employer. To do this, the agent must have the authority to sign for the employer under an agency agreement (either oral, written, or implied) that is valid under the state law and must add to his or her signature the caption "For: (name of employer)".

NOTE: Failure to sign the Form 4804 may delay processing or will result in your file being returned to you unprocessed.

.03 Although a duly authorized agent may sign the Form 4804, the employer is responsible for the accuracy of the Form 4804 and the returns filed. The employer will be liable for penalties for failure to comply with filing requirements.

.04 Be sure to include Form 4804, 4802 or computer-generated substitutes with your magnetic media shipment. D**O NOT MAIL YOUR MAGNETIC MEDIA AND THE TRANSMITTAL DOCUMENTS SEPARATELY.**

.05 Indicate on Form 4804, in the block captioned "Combined Total Payee Records," the total number of establishments being reported in this shipment. This figure should match the total number of records in your magnetic media file.

.06 **DO NOT SUBMIT THE SAME INFORMATION ON PAPER FORMS THAT YOU SUBMIT MAGNETICALLY/ELECTRONICALLY**. This does not mean that corrected documents are not to be filed. If a return has been prepared and submitted improperly, you must file a corrected return as soon as possible. Refer to Part A, Sec. 13 for requirements and instructions for filing corrected returns.

.07 If an allocation of tips is based on a good faith agreement, a copy of this agreement must accompany the submission.

.08 If, under Rev. Proc. 86–21, 1986–1 C.B. 560, the District Director granted the establishment a percentage of gross receipts of less than 8%, a copy of the determination letter must be sent with the submission. Employers with more than one establishment can receive approval from one district in each Internal Revenue Service region where the establishments are located (See sec. 31.6053–3(h)(4) of the Employment Tax Regulations).

.09 Before submitting your magnetic/electronic file, include the following:

(a) A **signed** Form 4804, Transmittal of Information Returns Reported Magnetically/Electronically, along with a Form 4802, Transmittal of Information Returns Reported Magnetically/Electronically(Continuation), if you submit data for multiple employers. These forms must be mailed the same day electronic files are submitted.

(b) Your media (tape, diskette, or cartridge) with an external identifying label. Notice 210 describes the information which should be included on this self-prepared label.

(c) On the outside of the shipping container, affix the label, IRB Special Projects. This label is included in the publication.

☛ **Note: See Part B, Section 6 for electronic submission requirements.**

.10 IRS/MCC will not pay or accept "Collect on Delivery" or "Charged to IRS" shipments of reportable tax information that an individual or organization is legally required to submit.

SEC. 9. FILING DATES

.01 Magnetic media reporting to IRS for Form 8027 must be on a calendar year basis. The due date of either paper or magnetically/electronically reported Forms 8027 is the last day of February.

.02 If the due date falls on a Saturday, Sunday, or legal holiday, filing Form 8027 on the next day that is not a Saturday, Sunday, or legal holiday will be considered timely.

SEC. 10. EXTENSIONS OF TIME TO FILE

.01 An extension of time to file may be requested for Forms 8027, 1099, 1098, 5498, W–2G, W–2, and 1042–S.

.02 Form 8809, Request for Extension of Time To File Information Returns, should be submitted to IRS/MCC. This form may be used to request an extension of time to file information returns submitted on paper, magnetically or electronically.

.03 Requesting an extension of time for multiple employers may be done by submitting Form 8809 and attaching a list of the employer names and their TINs (EIN or SSN). ***The listing must be attached to ensure the extension is recorded for all employers.*** *Form 8809 may be computer-generated or photocopied. Be sure that all the pertinent information is included.*

.04 Requests for extensions of time for multiple employers will be responded to with one approval letter, accompanied by a list of employers covered under that approval.

.05 **As soon as it is apparent** that an extension of time to file is needed, Form 8809 may be submitted. When granted, the extension will be for 30 days. It will take a minimum of 30 days for IRS/MCC to respond to an extension request. Under certain circumstances, a request for an extension of time could be denied. *When a denial letter is received, any additional or necessary information may be resubmitted within 20 days. When requesting an extension of time,* **do not** *hold your files waiting for a response.*

.06 While very difficult to obtain, if an additional extension of time is needed, a second Form 8809 must be submitted before the end of the initial extension period. Line 7 on the form should be checked to indicate that an additional extension is being requested. A second 30-day extension will be approved **only** in cases of extreme hardship or catastrophic events.

.07 ***Form 8809 must be*** **postmarked no later than the due date of the return** ***for which an extension is requested. If requesting an extension of time to file several types of forms, use one Form 8809, but the Form 8809 must be postmarked no later than the earliest due date. For example, if requesting an extension of time to file both Forms 8027 and 5498, submit Form 8809 postmarked on or before the last day of February.***

.08 *If an extension request is approved, the approval letter should be kept on file. The approval letter or copy of the approval letter for extension of time should not be sent to IRS/MCC with the magnetic/electronic file or to the service center where the paper returns are filed.*

.09 *Request an extension for only one tax year.*

.10 *The extension request must be signed by the employer or a person who is duly authorized to sign a return, statement or other document for the employer.*

.11 *Failure to properly complete and sign the Form 8809 may cause delays in processing the request or result in a denial. Carefully read and follow the instructions on the back of the Form 8809.*

.12 *Form 8809 may be obtained by calling* ***1-800-TAX-FORM (1-800-829-3676).***

☛ **Note: AN EXTENSION OF TIME TO FILE IS NOT AN EXTENSION TO ISSUE THE FORM W–2 COPY TO THE EMPLOYEE.**

.13 Request an extension of time to furnish the statements to recipients of Forms W–2 by submitting a letter to IRS/MCC containing the following information:

(a) Employer name
(b) TIN
(c) Address
(d) Type of return (W-2)
(e) Specify that the extension request is to provide W-2 statements to recipients
(f) Reason for delay
(g) Signature of employer or person duly authorized

Requests for an extension of time to furnish the statements for Forms W-2 to recipients are not automatically approved; however, if approved, generally an extension will allow a maximum of 30 additional days from the due date to furnish the statements to the recipients. The request must be postmarked by the date on which the statements are due to the recipients.

SEC. 11. PROCESSING OF MAGNETIC/ELECTRONIC RETURNS

.01 All data received at IRS/MCC for processing will be given the same protection as individual returns (Form 1040). IRS/MCC will process your magnetic/electronic files to ensure the records were formatted and coded according to this revenue procedure.

.02 If the data is formatted incorrectly, the file will be returned for replacement accompanied with a Media Tracking Slip (Form 9267). When media is returned, it is because IRS/MCC encountered errors (not limited to format) and was unable to process the media; therefore, requiring a replacement. Open all packages immediately.

.03 Files must be corrected and returned with the Media Tracking Slip (Form 9267) to IRS/MCC within 45 days from the date of the letter IRS/MCC included with the returned files. A penalty for failure to file correct information returns by the due date will be assessed if the files are not corrected and returned within the 45 days **or if the incorrect files are returned by IRS/MCC for replacement more than two times.** A penalty for intentional disregard of filing requirements will be assessed if a replacement file is not received.

.04 Files will not be returned to you after successful processing. Therefore, if you want proof that IRS/MCC received your shipment, you may use a carrier that provides proof of delivery.

.05 To distinguish between a correction and a replacement, the following definitions have been provided:

(a) A correction is a record submitted by the employer/transmitter to correct a record that was successfully processed by IRS, but contained erroneous information.

(b) A replacement is media that IRS has returned because of format errors or data discrepancies encountered during processing. After necessary changes have been made, the media must be returned to IRS/MCC for processing.

SEC. 12. PENALTIES

.01 The Revenue Reconciliation Act of 1989 changed the penalty provisions for any documents including corrections, which are filed after the original filing date for the return. The penalty for failure to file correct information returns is "time sensitive," in that prompt correction of failures to file, or prompt correction of errors on returns that were filed, can lead to reduced penalties.

— The penalty generally is $50 for each information return that is not filed, or is not filed correctly, by the prescribed filing date, with a maximum penalty of $250,000 per year ($100,000 for certain small businesses with average annual gross receipts, over the most recent 3-year period, not in excess of $5,000,000). The penalty generally is reduced to:

— $30 for each failure to comply if the failure is corrected more than 30 days after the return was due, but on or before August 1 of the calendar year in which the return was due, with a maximum penalty of $150,000 per year ($50,000 for certain small businesses with average annual gross receipts, over the most recent 3-year period, not in excess of $5,000,000).

— $15 for each failure to comply if the failure is corrected within 30 days after the date the return was due, with a maximum penalty of $75,000 per year ($25,000 for certain small businesses with average annual gross receipts, over the most recent 3-year period, not in excess of $5,000,000).

.02 Penalties can be waived if failures were due to reasonable cause and not to willful neglect. In addition, section 6721(c)of the Code provides a de minimis rule that if:

(a) information returns have been filed but were filed with incomplete or incorrect information, and

(b) the failures are corrected on or before August 1 of the calendar year in which the returns were due, then the penalty for filing incorrect returns (but not the penalty for filing late) will not apply to the greater of 10 returns or one-half of 1 percent of the total number of information returns you are required to file for the calendar year.

.03 **Intentional Disregard of Filing Requirements** — If any failure to file a correct information return is due to intentional disregard of the filing and correct information requirements, the penalty is at least $100 per information return with no maximum penalty.

SEC. 13. CORRECTED RETURNS, SUBSTITUTE FORMS, AND COMPUTER-GENERATED FORMS

.01 If returns must be corrected, approved magnetic/electronic filers must provide such corrections magnetically/electronically if you have 250 or more. If your information is filed magnetically/electronically, corrected returns are identified by using the "Corrected 8027 Indicator" in field position 370 of the employer record. Form 4804 must accompany the shipment, and the box for correction should be marked in Block 1 of the form. (See Part A, Sec. 11.05 for the definition of corrections.)

.02 If corrections are not submitted on magnetic media, employers must submit them on official Forms 8027. Substitute forms that have been previously approved by IRS, or computer-generated forms that are exact facsimiles of the official form (except for minor page size or print style deviations), may be submitted without obtaining IRS approval before using the form.

.03 Employers/establishments may send corrected paper Forms 8027 to IRS at the address shown in Part A, Sec. 14.01. Corrected paper returns are identified by marking the "AMENDED" check box on Form 8027.

SEC. 14. EFFECT ON PAPER RETURNS

.01 If you are filing more than one paper Form 8027, you must attach a completed Form 8027–T, Transmittal of Employer's Annual Information Return of Tip Income and Allocated Tips, to the Forms 8027 and send to:

Internal Revenue Service Center
Andover, MA 05501

IRS/MCC processes Forms 8027 submitted magnetically/electronically only. Do not send paper Forms 8027 to IRS/MCC.

.02 If part of a submission is filed magnetically/electronically and the rest of the submission is filed on paper Forms 8027, send the paper forms to the Andover Service Center. For example, you filed your Forms 8027 magnetically/electronically with IRS/MCC, and later you found that some of the forms you filed need correcting. Because of the low volume of corrections, you submit the corrections on paper Forms 8027. You must send these corrected Forms 8027 along with Form 8027-T to the Andover Service Center.

SEC. 15. DEFINITIONS

ELEMENT	DESCRIPTION
EIN	A nine-digit Employer Identification Number which has been assigned by IRS to the reporting entity.
Employer	The organization supplying the information.
Establishment	A large food or beverage establishment that provides food or beverage for consumption on the premises; where tipping is a customary practice; and where there are normally more than 10 employees who work more than 80 hours on a typical business day during the preceding calendar year.
More than 10 employees	An employer is considered to have more than 10 employees on a typical business day during the calendar year if half the sum of: the average number of employee hours worked per business day in the calendar month in which the aggregate gross receipts from food and beverage operations were greatest, **plus** the average number of employee hours worked per business day in the calendar month in which the total aggregate gross receipts from food and beverage operations were the least, **equals** more than 80 hours.
Employees hours worked	The average number of employee hours worked per business day during a month is figured by dividing the total hours worked during the month by all your employees who are employed in a food or beverage operation by the average number of days in the month that each food or beverage operation at which these employees worked was open for business.
File	For the purpose of this revenue procedure, a file consists of all magnetic/electronic records submitted by an Employer or Transmitter.
Transmitter	Person or organization preparing magnetic/electronic file(s). May be Employer or agent of Employer.
Transmitter Control Code (TCC)	A five-character alpha/numeric code assigned by IRS to the transmitter prior to actual filing magnetically/electronically. This number is inserted in the record and must be present. An application (Form 4419) must be filed with IRS to receive this number.
Replacement	A replacement is an information return that IRS/MCC has returned to the transmitter due to errors encountered during processing.
Correction	A correction is an information return submitted by the transmitter to correct an information return that was previously submitted to and processed by IRS/MCC, but contained erroneous information.

PART B. MAGNETIC/ELECTRONIC SPECIFICATIONS

SEC. 1. GENERAL

.01 The magnetic/electronic specifications contained in this part of the revenue procedure define the required format and contents of the records to be included in the file.

.02 A *self prepared media label must be affixed to each piece of media submitted for processing. Notice 210 provides instructions on how to complete a self-prepared media label.*

.03 The record format in Part B, Sec. 7 applies to both magnetic and electronic files.

SEC. 2. TAPE SPECIFICATIONS

.01 In most instances, IRS/MCC can process any compatible tape files. Compatible tape files must meet any one set of the following:

(a) 9-track EBCDIC (Extended Binary Coded Decimal Interchange Code) with

(1) Odd Parity and
(2) A density of 1600 or 6250 BPI
(3) If you use Unisys Series 1100, you must submit an interchange tape.
(b) 9-track ASCII (American Standard Coded Information Interchange) with
(1) Odd Parity and
(2) A density of 1600 or 6250 BPI

Please be consistent in the use of recording codes and density on your files. If files are generated in more than one recording code and/or density, multiple shipments would be appreciated.

.02 All compatible tape files must have the following characteristics:

(a) Type of Tape – ½ inch mylar base, oxide coated; computer grade magnetic tape on reels up to 2400 feet (731.52 m) within the following specifications:

(1) Tape thickness: 1.0 or 1.5 mils
(2) Reel diameter: 10.5 inch (26.67 cm), 8.5 inch (21.59 cm), or 7 inch (17.78 cm).

.03 All records have a fixed record length of 372 positions.

.04 The tape record defined in this revenue procedure may be blocked or unblocked, subject to the following:

(a) All records except the header and trailer labels may be blocked.

(b) If records are blocked, the block can not exceed 32,736 tape positions. The block length must be evenly divisible by 372.

(c) If the use of blocked records would result in a short block, all remaining positions of the block MUST be filled with 9's. **DO NOT PAD A BLOCK WITH BLANKS.** Padding a block with blanks will result in a short record, which will cause math computation errors. Your tape will then be returned for correction.

.05 For the purposes of this revenue procedure the following conventions must be used:

Header label:

(a) Transmitters may use standard headers provided they begin with 1HDR, HDR1, VOL1, or VOL2.

(b) Consists of a maximum of 80 positions.

(c) Header and trailer labels are optional unless more than one reel is being submitted. If more than one reel is being submitted, header and trailer labels are required. IRS/MCC PREFERS STANDARD OR ANSI LABELED TAPES. IF YOU SUBMIT AN UNLABELED TAPE, THIS MUST BE INDICATED ON THE EXTERNAL LABEL AND ON THE FORM 4804 OR COMPUTER-GENERATED SUBSTITUTE.

Trailer label:

(a) Standard trailer labels may be used provided that they begin with 1EOR, 1EOF, EOV1, or EOV2.

(b) Consists of a maximum of 80 positions.

(c) Header and trailer labels are optional unless more than one reel is being submitted. If more than one reel is being submitted, header and trailer labels are required.

Tape Mark:

(a) Used to signify the physical end of the recording on tape.

(b) May follow the header label and precede and/or follow the trailer label.

SEC. 3. DISKETTE SPECIFICATIONS

IRS-MCC will discontinue processing 5 ¼ inch diskettes in the future. Filers who use 5 ¼ inch diskettes are encouraged to explore other methods of submitting information returns magnetically/electronically.

.01 To be compatible, a diskette file must meet the following specifications:

(a) 5 ¼ or 3 ½ inches in diameter.

(b) Data must be recorded in standard ASCII code.

(c) Records must be fixed length of 372 bytes.

(d) Delimiter character commas (,) must not be used.

(e) Positions 371 and 372 of each record have been reserved for carriage return/line feed (cr/lf) characters.

(f) Filename of ATMTAX must be used. Do not enter any other data in this field. If a file will consist of more than one diskette, the filename will contain a 3-digit extension. This extension will indicate the sequence of the diskette within the file. For example, the first diskette will be named ATMTAX.001, the second diskette will be ATMTAX.002, etc.

(g) A file may contain more than one diskette as long as the filename conventions are adhered to.

(h) Diskettes must meet one of the following specifications:

Capacity	Tracks	Sides/Density	Sector Size
1.44 mb	96tpi	hd	512
1.44 mb	135tpi	hd	512
1.2 mb	96tpi	hd	512
720 kb	48tpi	ds/dd	512
360 kb	48tpi	ds/dd	512

.02 IRS requires that 5 ¼ and 3 ½ inch diskettes be created using MS/DOS. Diskettes created using other operating systems are not acceptable. We strongly recommend that you submit a test file if this will be your first time filing on diskette.

.03 Deviations from the prescribed format will not be acceptable.

Sec. 4. TAPE CARTRIDGE SPECIFICATIONS

.01 In most instances, IRS/MCC can process tape cartridges that meet the following specifications:

(a) Must be IBM 3480, 3490, 3490E, or AS400 compatible.

(b) Must meet American National Standard Institute (ANSI) standards, and have the following characteristics:

(1) Tape cartridges will be ½-inch tape contained in plastic cartridges which are approximately 4-inches by 5-inches by 1-inch in dimension.

(2) Magnetic tape will be chromium dioxide particle based ½-inch tape.

*(3) Cartridges must be 18-track or 36-track parallel (See **Note**).*

(4) Cartridges will contain 37,871 CPI or 75,742 CPI (characters per inch).

(5) Mode will be full function.

(6) The data may be compressed using EDRC (Memorex) or IDRC (IBM) compression.

(7) Either EBCDIC (Extended Binary Coded Decimal Interchange Code) or ASCII (American Standard Coded Information Interchange) may be used.

.02 The tape cartridge records defined in this revenue procedure may be blocked subject to the following:

*(a) A block **must not** exceed 32,736 tape positions.*

*(b) If the use of blocked records would result in a short block, all remaining positions of the block must be filled with 9s; however, the last block of the file may be filled with 9s or truncated. **Do not pad a block with blanks.***

(c) All records, except the header and trailer labels, may be blocked or unblocked. A record may not contain any control fields or block descriptor fields which describe the length of the block or the logical records within the block. The number of logical records within a block (the blocking factor) must be constant in every block with the exception of the last block which may be shorter (see item b above). The block length must be evenly divisible by 372.

(d) Records may not span blocks.

.03 Tape cartridges may be labeled or unlabeled.

.04 For the purposes of this revenue procedure, the following must be used:

Tape Mark:

(a) Used to signify the physical end of the recording on tape.

(b) For even parity, use BCD configuration 001111 (8421).

(c) May follow the header label and precede and/or follow the trailer label.

☞ **Note: Filers should indicate on the external media label and transmittal Form 4804 whether the cartridge is 36-track or 18-track.**

SEC. 5. 8MM, 4MM, AND QUARTER INCH CARTRIDGE SPECIFICATIONS

.01 In most instances, IRS/MCC can process 8mm tape cartridges that meet the following specifications:

(a) Must meet American National Standard Institute (ANSI) standards, and have the following characteristics:

(1) Created from an AS400 operating system only.

(2) 8mm (.315-inch) tape cartridges will be 2 ½-inch by 3 ¾-inch.

(3) The 8mm tape cartridges must meet the following specifications:

Tracks	*Density*	*Capacity*
1	*20 (43245 BPI)*	*2.5 Gb*
1	*21 (45434 BPI)*	*5 Gb*

(4) Mode will be full function.

(5) Compressed data is not acceptable.

(6) Either EBCDIC (Extended Binary Coded Decimal Interchange Code) or ASCII (American Standard Coded Information Interchange) may be used. However, IRS/MCC encourages the use of EBCDIC. This information must appear on the external media label affixed to the cartridge.

(7) A file may consist of more than one cartridge, however, no more than 250,000 documents may be transmitted per file or per cartridge. The filename, for example; ATMTAX, will contain a three digit extension. The extension will indicate the sequence of the cartridge within the file 1 of 3, 2 of 3, and 3 of 3 and would appear in the header label ATMTAX.001, ATMTAX.002, and ATMTAX.003 on each cartridge of the file.

.02 The 8mm (.315-inch) tape cartridge records defined in this revenue procedure may be blocked subject to the following:

(a) A block **must not** *exceed 32,736 tape positions.*

(b) If the use of blocked records would result in a short block, all remaining positions of the block must be filled with 9's; however, the last block of the file may be filled with 9's or truncated. **Do not pad a block with blanks.**

(c) All records, except the header and trailer labels, may be blocked or unblocked. A record may not contain any control fields or block descriptor fields which describe the length of the block or the logical records within the block. The number of logical records within a block (the blocking factor) must be constant in every block with the exception of the last block which may be shorter (see item (b) above). The block length must be evenly divisible by 372.

(d) Records may not span blocks.

(e) No more than 250,000 documents per cartridge and per file.

.03 Various COPY commands have been successful, however, the SAVE OBJECT COMMAND is not acceptable.

.04 For faster processing, IRS/MCC encourages transmitters to use header labeled cartridges. ATMTAX may be used as a suggested filename.

.05 For the purposes of this revenue procedure, the following must be used:

Tape Mark:

(a) Used to signify the physical end of the recording on tape.

(b) For even parity, use BCD configuration 001111 (8421).

(c) May follow the header label and precede and/or follow the trailer label.

.06 IRS/MCC can only read one data file on a tape. A data file is a group of records which may or may not begin with a tapemark, but must end with a trailer label. Any data beyond the trailer label cannot be read by IRS programs.

.07 4mm (.157-inch) cassettes are now acceptable with the following specifications:

(a) 4 mm cassettes will be 2 ¼-inch by 3-inch.

(b) The tracks are 1 (one).

(c) The density is 19 (61000 BPI).

(d) The typical capacity is DDS (DAT data storage) at 1.3 Gb or 2 Gb, or DDS–2 at 4Gb.

(e) The general specifications for 8mm cartridges will also apply to the 4 mm cassettes.

.08 Various Quarter Inch Cartridges (QIC)(¼-inch) are also acceptable.

(a) QIC cartridges will be 4" by 6".

(b) QIC cartridges must meet the following specifications:

Size	*Tracks*	*Density*	*Capacity*
QIC–11	*4/5*	*4 (8000 BPI)*	*22Mb or 30Mb*
QIC–24	*8/9*	*5 (8000 BPI)*	*45Mb or 60Mb*
QIC–120	*15*	*15 (10000 BPI)*	*120Mb or 200Mb*
QIC–150	*18*	*16 (10000 BPI)*	*150Mb or 250Mb*
QIC–320	*26*	*17 (16000 BPI)*	*320Mb*
QIC–525	*26*	*17 (16000 BPI)*	*525Mb*
QIC–1000	*30*	*21 (36000 BPI)*	*1Gb*
QIC–1350	*30*	*18 (51667 BPI)*	*1.3Gb*
QIC–2Gb	*42*	*34 (40640 BPI)*	*2Gb*

(c) The general specifications that apply to 8mm cartridges will also apply to QIC cartridges.

SEC. 6. ASYNCHRONOUS (IRP-BBS) ELECTRONIC FILING SPECIFICATIONS

.01 Asynchronous electronic filing of Forms 8027, originals, corrections, and replacements is offered as an alternative to magnetic media (tape, tape cartridge, or diskette) or paper filing, but is not a requirement. Electronic filing using the Information Reporting Program-Bulletin Board System (IRP-BBS) will fulfill the magnetic media requirements for those employers who are required to file magnetically. It may also be used by employers who are under the filing threshold requirement, but would prefer to file their information returns this way. If the original file was sent magnetically, but was returned for replacement, the replacement may be transmitted electronically. Also, if the original file was submitted via magnetic media, any corrections may be transmitted electronically.

.02 The electronic filing of information returns is not affiliated with the Form 1040 electronic filing program. These two programs are totally independent, and filers must obtain separate approval to participate in each of them. All inquiries concerning the electronic filing of information returns should be directed to IRS/MCC. IRS/MCC personnel cannot answer questions or assist taxpayers in the filing of Form 1040 tax returns. Filers with questions of this nature will be directed to the Customer Service toll-free number ***(1-800-829-1040)*** *for assistance.*

.03 Filers participating in the electronic filing program for information returns will submit their returns to IRS/MCC electronically and not through magnetic media or paper filing. Files submitted in this manner must be in standard ASCII code.

.04 If a request for extension is approved, transmitters who file electronically will be granted an extension of 30 days to file. Part A, Sec. 10, explains procedures for requesting extensions of time. Filers are encouraged to file their data as soon as possible.

.05 The format of the record is the same for electronically filed records as it is for 5 ¼ and 3 ½ inch diskettes, tapes, and tape cartridges; however, it must be in standard ASCII code.

.06 Filers must obtain a Transmitter Control Code (TCC) prior to submitting their files electronically. (Filers who currently have a TCC for filing Forms 8027 do not have to request a second TCC for electronic filing.) Refer to Part A, Sec. 6, for information on how to obtain a TCC.

.07 Filers using IRP-BBS assign their own passwords and do not need special approval.

.08 With all passwords, it is the user's responsibility to remember the password and not allow the password to be compromised. However, if filers do forget their password, call ***304-263-8700*** *for assistance.*

☛ **Note: Passwords on the IRP-BBS are case sensitive.**

.09 Electronically filed information may be submitted to IRS/MCC 24 hours a day, 7 days a week. Technical assistance will be available Monday through Friday between 8:30 a.m. and 4:30 p.m. Eastern Time by calling ***304-263-8700.***

.10 Filers may submit as many documents as they choose electronically. Filers are allowed 240 minutes a day; however, more time may be requested if needed.

.11 ***Do not transmit data using IRP-BBS January 1 through January 7.*** *This will allow time for the IRP-BBS to be updated to reflect current year changes.*

.12 Data compression is encouraged when submitting information returns by way of the IRP-BBS. MCC has the ability to decompress files created using several popular software compression programs such as ARC, LHARC, and PKZIP. Software data compression can be done alone or in conjunction with V.42bis hardware compression.

The time required to transmit information returns electronically will vary depending on the modem speed and the type of data compression used, if any. ***The time required to transmit a file can be reduced by as much as 85 percent by using software compression and hardware compression.***

The following are actual transmission rates for forms 1099 achieved in test uploads at MCC using compressed files (PKZIP) and the XMODEM-1K protocol. The actual transmission rates will vary depending on the protocol that is used. (ZMODEM is normally the fastest protocol and XMODEM and KERMIT are the slower protocols.)

Transmission Speed in bps	*500 Records*	*2500 Records*	*10000 Records*
9600	*40 sec*	*2 min 50 sec*	*12 min 21 sec*
19200	*31 sec*	*1 min 34 sec*	*7 min 1 sec*
38400	*17 sec*	*36 sec*	*4 min 7 sec*

.13 Files submitted to IRP-BBS must have a unique filename; therefore, the IRP-BBS will build the filename that must be used. The name will consist of the filer's TCC, submission type (T = Test, P = Production, C = Correction, and R = Replacement) and a sequence number. Filers may call the file anything they choose on their end. The sequence number will be incremented every time the filers send, or attempt to send, a file. Record the upload date, time, and filename. This information will be needed by MCC in order to identify the file if assistance is required and to complete Form 4804.

.14 The results of the electronic transmission will be posted to the (F)ile Status area of the IRP-BBS; however, no further processing will occur until the signed Form 4804 is received. The transmitter must send or fax the signed Form 4804 the same day the electronic transmission is made. No return is considered filed until a Form 4804 is received by IRS/MCC.

.15 Form 4804 can be ordered by calling the IRS toll-free forms and publication order number 1-800-TAX-FORM, (1-800-829-3676), downloaded from the IRP-BBS, or it may be computer-generated. A copy of the form is also available in the back of this publication. If a filer chooses to computer-generate Form 4804, all of the information contained on the original form, including the affidavit, must also be contained on the computer-generated form.

.16 Forms 4804 are to be mailed to the following addresses:

If by Postal Service:

IRS-Martinsburg Computing Center
Information Reporting Program
Attn.: Electronic Filing Coordinator
P. O. Box 1359
Martinsburg, WV 25402-1359

☛ **Note: The ZIP Code has changed from 25401-1359 to 25402-1359 for the IRS P.O. Box addresses for Martinsburg, WV.**

If by air or truck freight:

IRS-Martinsburg Computing Center
Information Reporting Program
Attn.: Electronic Filing Coordinator
Route 9 and Needy Road
Martinsburg, WV 25401

.17 A signed Form 4804 submitted for electronically filed information returns may be faxed to IRS/MCC at the following number: 304-264-5602. Faxed transmittals will allow IRS/MCC to begin processing the file immediately.

.18 The IRP-BBS is an electronic bulletin board system available to filers of information returns. In addition to filing information returns electronically, the IRP-BBS provides other capabilities. Some of the advantages of IRP-BBS are as follows:

(1) Notification within two weeks as to the acceptability of the data transmitted.

(2) Immediate access to the latest changes and updates that affect the Information Reporting Program at IRS/MCC (program, legislative, etc.).

(3) Access to publications such as the Publication 1239 as soon as they are available.

(4) Capability to communicate with IRS/MCC personnel.

(5) Ability to retrieve information and files applicable to the IRP-BBS.

.19 The IRP-BBS is available for public use and accessible using various personal computer communications equipment; however, electronic submission of information returns is limited to holders of valid TCCs. A TCC is not needed to access those portions of the IRP-BBS that contain forms and publications or to leave questions or messages for IRS/MCC personnel.

.20 Filers using IRP-BBS can determine the acceptability of files submitted by checking the file status area of the bulletin board. These reports are not immediately available but will be available within two weeks after the transmission is received by IRS/MCC.

.21 Contact the IRP-BBS by dialing 304-264-7070. The communication software settings for IRP-BBS are:

— No parity
— Eight data bits
— One stop bit
— Full duplex

The communication software should be set up to use the fastest speed allowed by the filer's modem.

.22 Due to the large number of communication products available, it is impossible to provide specific information on a particular software package or hardware configuration. Filers should contact their software or hardware supplier for assistance.

.23 IRP-BBS software provides a menu-driven environment allowing access to different parts of IRP-BBS. Whenever possible, IRS/MCC personnel will provide assistance in resolving any communication problems with IRP-BBS.

.24 IRP-BBS can be accessed at speeds from 1200 to 28,800 bps. The speed is automatically negotiated for connection at the speed of the calling modem. The communication standards supported include Industry Standard 212A, V.22bis, V.32, V.32bis, V.34, and V.FC. Point-to-point error control is supported using the V.42 ITU–T standard or MNP 2–4. Data compression is supported using V.42bis ITU–T standard or MNP5.

.25 The following information will be requested to set up the filer's user profile when logging onto the IRP-BBS for the first time.

(1) Enter the letter that corresponds to the filer's terminal from the following:

<A>	*IBM PC*	*<B>*	*IBM w/ANSI*	*<C>*	*Hyperterm*
<D>	*Terminal*	*<E>*	*VT-100*	*<F>*	*<CR>*

Most PCs, clones, etc., will select the IBM PC emulation. Machines with color, CGA, EGA, or VGA should select IBM w/ANSI.

(2) Upper/lower case, line feed needed, O (zero) nulls after each <CR>, do you wish to modify this? (Most users answer no.)

Common Problems

Problem	*Probable Cause*	*Solution*
File does not upload/download	*Not starting communication when prompted by 'Awaiting Start Signal'*	*Start upload/download on filers end*
All files not processed	*Compressing several files into one filename*	*Compress only one file for every filename*
Replacement needed	*Original data does not meet processing and/or format requirements*	*Replacement must be submitted within 45 days of original transmission*
Cannot determine file status	*Not dialing back thru IRP-BBS to check the status of the file*	*Two weeks after sending a file, check under (F)ile Status for notification of acceptability*
Transfer aborts before it starts	*Transfer protocol mismatch*	*Ensure protocols match on both the sending and receiving ends*
Loss of carrier during session	*Incorrect modem settings on user's end*	*Reference your modem manual about increasing the value of the S10 register*
Unreadable screens after selecting IBM w/ANSI	*ANSI.SYS driver not loaded in the user's PC*	*Select non ANSI under (Y)our settings*
IRS cannot complete final processing of data	*User did not send the Form 4804*	*Send completed Form 4804 the same day as the electronic transmission*
IRS cannot determine which file is being replaced	*User did not indicate which file is being replaced*	*Must enter the filename being replaced under the replacement option*
IRS cannot determine the type of file being sent	*User incorrectly indicated T, P, C, or R for the type of file*	*When prompted, enter the correct type of file being sent*
Replacement file not replaced within 45 days	*User did not dial back thru IRP-BBS to check status of file*	*Two weeks after sending file, check under (F)ile Status for notification of acceptability*
Duplicate data	*Transmitter sends corrections for entire file*	*Only submit corrections for incorrect records*

SEC. 7. RECORD FORMAT AND LAYOUT

FORM 8027 RECORD FORMAT

Field Position	Field Title	Length	Description and Remarks
1	Establishment Type	1	**REQUIRED.** This digit identifies the kind of establishment. Enter the number which describes the type of establishment, as shown below: 1 for an establishment that serves evening meals only (with or without alcoholic beverages). 2 for an establishment that serves evening meals and other meals (with or without alcoholic beverages). 3 for an establishment that serves only meals other than evening meals (with or without alcoholic beverages). 4 for an establishment that serves food, if at all, only as an incidental part of the business of serving alcoholic beverages.

FORM 8027 RECORD FORMAT (Continued)

Field Position	Field Title	Length	Description and Remarks
2–6	Establishment Serial Numbers	5	**REQUIRED.** These five digit Serial Numbers are for identifying individual establishments of an employer reporting under the same EIN. The employer shall assign each establishment a unique number. **NUMERICS ONLY.**
7–46	Establishment Name	40	**REQUIRED.** Enter the name of the establishment. Left justify and fill unused positions with blanks. **ALLOWABLE CHARACTERS ARE ALPHAS, NUMERICS, BLANKS, HYPHENS, AMPERSANDS, AND SLASHES.**
47–86	Establishment Street Address	40	**REQUIRED.** Enter the mailing address of the establishment. Street address should include number, street, apartment or suite number (or P O Box if mail is not delivered to street address). Left justify and blank fill.

☛ **Note: The only allowable characters are alphas, blanks, numerics, ampersands, hyphens and slashes. Punctuation such as periods and commas are not allowed and will cause your file to be returned. For example, the address 210 N. Queen St., Suite #300 must be entered as 210 N Queen St Suite 300.**

87–111	Establishment City	25	**REQUIRED.** Enter the city, town, or post office. Left justify and blank fill.

☛ **Note 1: The only allowable characters are alphas, blanks, numerics, ampersands, hyphens and slashes. Punctuation such as periods and commas are not allowed and will cause your file to be returned. For example, the city St. Louis must be entered as St Louis.**

112–113	Establishment State	2	**REQUIRED.** Enter state code of the establishment; must be one of the following:

STATE	*CODE*	*STATE*	*CODE*
Alabama	AL	Montana	MT
Alaska	AK	Nebraska	NE
Arizona	AZ	Nevada	NV
Arkansas	AR	New Hampshire	NH
California	CA	New Jersey	NJ
Colorado	CO	New Mexico	NM
Connecticut	CT	New York	NY
Delaware	DE	North Carolina	NC
District of Columbia	DC	North Dakota	ND
Florida	FL	Ohio	OH
Georgia	GA	Oklahoma	OK
Hawaii	HI	Oregon	OR
Idaho	ID	Pennsylvania	PA
Illinois	IL	Rhode Island	RI
Indiana	IN	South Carolina	SC
Iowa	IA	South Dakota	SD
Kansas	KS	Tennessee	TN
Kentucky	KY	Texas	TX
Louisiana	LA	Utah	UT
Maine	ME	Vermont	VT
Maryland	MD	Virginia	VA
Massachusetts	MA	Washington	WA

FORM 8027 RECORD FORMAT (Continued)

Field Position	Field Title	Length	Description and Remarks
STATE		*CODE*	*STATE* *CODE*
Michigan		MI	West Virginia WV
Minnesota		MN	Wisconsin WI
Mississippi		MS	Wyoming WY
Missouri		MO	
114–122	Establishment ZIP Code	9	**REQUIRED.** Enter the complete nine-digit ZIP Code of the establishment. If using a five-digit ZIP Code, left justify the five-digit ZIP Code and fill the remaining four positions with blanks.
☞ **Note: MUST BE NINE NUMERICS OR FIVE NUMERICS AND FOUR BLANKS. DO NOT ENTER THE DASH.**			
123–131	Employer Identification Number	9	**REQUIRED.** Enter the nine digit number assigned to the employer by IRS. **DO NOT ENTER HYPHENS, ALPHAS, ALL 9's, OR ALL ZEROS.**
132–171	Employer Name	40	**REQUIRED.** Enter the name of the employer as it appears on your tax forms (e.g., Form 941). Any extraneous information must be deleted. Left justify and blank fill. **ALLOWABLE CHARACTERS ARE ALPHAS, BLANKS, NUMERICS, AMPERSANDS, HYPHENS, AND SLASHES.**
172–211	Employer Street Address	40	**REQUIRED.** Enter mailing address of employer. Street address should include number, street, apartment or suite number (or P O Box if mail is not delivered to street address). Left justify and blank fill.
☞ **Note: The only allowable characters are alphas, blanks, numerics, ampersands, hyphens and slashes. Punctuation such as periods and commas are not allowed and will cause your file to be returned. For example, the address 210 N. Queen St., Suite #300 must be entered as 210 N Queen St Suite 300.**			
212–236	Employer City	25	**REQUIRED.** Enter the city, town, or post office. Left justify and blank fill.
☞ **Note: The only allowable characters are alphas, blanks, numerics, ampersands, hyphens and slashes. Punctuation such as periods and commas are not allowed and will cause your file to be returned. For example, the city St. Louis must be entered as St Louis.**			
237–238	Employer State	2	**REQUIRED.** Enter state code of employer. Must be one of the abbreviations shown in the state abbreviation table for Establishment State (field positions 112–113).
239–247	Employer ZIP Code	9	**REQUIRED.** Enter the complete nine-digit ZIP Code of the employer. If using a five-digit ZIP Code, left justify the five-digit ZIP Code and fill the remaining four positions with blanks.
☞ **Note: MUST BE NINE NUMERICS OR FIVE NUMERICS AND FOUR BLANKS. DO NOT ENTER THE DASH.**			
248–259	Charged Tips	12	**REQUIRED.** Enter the total amount of tips that are shown on charge receipts for the calendar year. Amount must be entered in U.S. dollars and cents. The right-most two positions represent cents. Right justify and zero fill. If no entry, zero fill. **NUMERICS ONLY. DO NOT ENTER DECIMAL POINTS, DOLLAR SIGNS, OR COMMAS.**

FORM 8027 RECORD FORMAT (Continued)

Field Position	Field Title	Length	Description and Remarks
260–271	Charged Receipts	12	**REQUIRED.** Enter the total sales for the calendar year other than carry-out sales or sales with an added service charge of 10 percent or more, that are on charge receipts with a charged tip shown. This includes credit card charges, other credit arrangements, and charges to a hotel room unless the employer's normal accounting practice consistently excludes charges to a hotel room. Do not include any state or local taxes in the amount reported. Amount must be entered in U.S. dollars and cents. The right-most two positions represent cents. Right justify and zero fill. If no entry, zero fill. **NUMERICS ONLY. DO NOT INCLUDE DOLLAR SIGNS, DECIMAL POINTS, OR COMMAS.**
272–283	Service Charge Less Than 10 Percent	12	**REQUIRED.** Enter the total amount of service charges less than 10 percent added to customer's bills and were distributed to your employees for the calendar year. In general, service charges added to the bill are not tips since the customer does not have a choice. These service charges are treated as wages and are included on Form W–2. For a more detailed explanation, see Rev. Rul. 19–28, 1969–1 C.B. 270. Amount must be entered in U.S. dollars and cents. The right-most two positions represent cents. Right justify and zero fill. If no entry, zero fill. **NUMERICS ONLY. DO NOT ENTER DOLLAR SIGNS, DECIMAL POINTS, OR COMMAS.**
284–295	Indirect Tips Reported	12	**REQUIRED.** Enter the total amount of tips reported by indirectly tipped employees (e.g., busboys, service bartenders, cooks) for the calendar year. Do not include tips received by employees in December of the prior tax year but not reported until January. Include tips received by employees in December of the tax year being reported, but not reported until January of the subsequent year. Amount must be entered in U.S. dollars and cents. The right-most two positions represent cents. Right justify and zero fill. If no entry, zero fill. **NUMERICS ONLY. DO NOT ENTER DOLLAR SIGNS, DECIMAL POINTS, OR COMMAS.**
296–307	Direct Tips Reported	12	**REQUIRED.** Enter the total amount of tips reported by directly tipped employees (e.g., waiters, waitresses, bartenders) for the calendar year. Do not include tips received by employees in December of the prior tax year but not reported until January. Include tips received by employees in December of the tax year being reported, but not reported until January of the subsequent year. Amount must be entered in U.S. dollars and cents. The right-most two positions represent cents. Right justify and zero fill. If no entry, zero fill. **NUMERICS ONLY. DO NOT ENTER DOLLAR SIGNS, DECIMAL POINTS, OR COMMAS**
308–319	Total Tips Reported	12	**REQUIRED.** Enter the total amount of tips reported by all employees (both indirectly tipped and directly tipped) for the calendar year. Do not include tips received in December of the prior tax year but not reported until January. Include tips received in December of the tax year being reported, but not reported until January of the subsequent year. Amount must be entered in U.S. dollars and cents. The right-most two positions represent cents. Right justify and zero fill. If no entry, zero fill. **NUMERICS ONLY. DO NOT ENTER DOLLAR SIGNS, DECIMAL POINTS, OR COMMAS.**

FORM 8027 RECORD FORMAT (Continued)

Field Position	Field Title	Length	Description and Remarks
320–331	Gross Receipts	12	**REQUIRED.** Enter the total gross receipts from the provision of food and/or beverages for this establishment for the calendar year. Do not include receipts for carry-out sales or sales with an added service charge of 10 percent or more. Do not include in gross receipts charged tips (field positions 248–259) shown on charge receipts unless you have reduced the cash sales amount because you have paid cash to tipped employees for tips they earned that were charged. Do not include state or local taxes in gross receipts. If you do not charge separately for food or beverages along with other services (such as a package deal for food and lodging), make a good faith estimate of the gross receipts attributable to the food or beverages. This estimate must reflect the cost of providing the food or beverages plus a reasonable profit factor. Include the retail value of complimentary food or beverages served to customers if tipping for them is customary and they are provided in connection with an activity engaged in for profit whose receipts would not be included as gross receipts from the provision of food or beverages (e.g., complimentary drinks served to customers at a gambling casino). Amount must be entered in U.S. dollars and cents. The right-most two positions represent cents. Right justify and zero fill. If no entry, zero fill. **NUMERICS ONLY. DO NOT ENTER DOLLAR SIGNS, DECIMAL POINTS, OR COMMAS.**
332–343	Tip Percentage Rate Times Gross Recipts	12	**REQUIRED.** Enter the amount determined by multiplying Gross Receipts for the year (field positions 320–331) by the Tip Percentage Rate (field positions 344–347). For example, if the value of Gross Receipts is "000045678900" and Tip Percentage Rate is "0800", multiply $456,789.00 by .0800 to get $36,543.12 and enter "000003654312". If tips are allocated using other than the calendar year, enter zeros; this may occur if you allocated tips based on the time period for which wages were paid or allocated on a quarterly basis. Amount must be entered in U.S.dollars and cents. The right-most two positions represent cents. Right justify and zero fill. **NUMERICS ONLY. DO NOT ENTER DOLLAR SIGNS, DECIMAL POINTS, OR COMMAS.**
344–347	Tip Percentage Rate	4	**REQUIRED.** Enter 8 percent (0800) unless a lower rate has been granted by the District Director. The determination letter must accompany the magnetic/electronic submission. **NUMERICS ONLY. DO NOT ENTER DECIMAL POINT.**
348–359	Allocated Tips	12	**REQUIRED.** If Tip Percentage Rate Times Gross Receipts (field positions 332–343)is greater than Total Tips Reported (field positions 308–319), then the difference becomes Allocated Tips. Otherwise, enter all zeros. If tips are allocated using other than the calendar year, enter the amount of allocated tips from your records. Amount must be entered in U.S. dollars and cents. The right-most two positions represents cents. Right justify and zero fill. **NUMERICS ONLY. DO NOT ENTER DOLLAR SIGNS, DECIMAL POINTS, OR COMMAS.**
360	Allocation Method	1	**REQUIRED.** Enter the allocation method used if Allocated Tips (field positions 348–359) are greater than zero as follows: 1) for allocation based on hours worked. 2) for allocation based on gross receipts.

FORM 8027 RECORD FORMAT (Continued)

Field Position	Field Title	Length	Description and Remarks
			3) for allocation based on a good faith agreement. The good faith agreement must accompany the magnetic/electronic submission. If Allocated Tips are equal to zero, enter 0 (zero).
			☛ **Note: Under Section 1571 of the Tax Reform Act of 1986, the method of allocation of tips based on the number of hours worked as described in Section 31.6053–3(f)(1)(iv) may be utilized only by an employer that employs less than the equivalent of 25 full-time employees at the establishment during the payroll period. Section 31.6053–3(j)(19) provides that an employer is considered to employ less than the equivalent of 25 full-time employees at an establishment during a payroll period if the average number of employee hours worked per business day during the payroll period is less than 200 hours.**
361–364	Number of Directly Tipped Employees	4	**REQUIRED.** Enter the total number (must be greater than zero) of directly tipped employees employed by the establishment for the calendar year. Right justify and zero fill. **NUMERICS ONLY.**
365–369	Transmitter Control Code (TCC)	5	**REQUIRED.** Enter the 5-digit Transmitter Control Code assigned by the IRS.
370	Corrected 8027 Indicator	1	**REQUIRED.** Enter blank for original return. Enter "G" for corrected return. A corrected return must be a complete new return replacing the original return.
371–372	Blank or cr/lf	2	Magnetic tape filers are required to enter blanks. Diskette filers may enter blanks or the carriage return/line feed characters (cr/lf).

FORM 8027 RECORD LAYOUT

Establishment Type	Establishment Serial Number	Establishment Name	Establishment Street Address
1	2–6	7–46	47–86

Establishment City	Establishment State	Establishment ZIP Code	Employer Identification Number
87–111	112–113	114–122	123–131

Employer Name	Employer Street Address	Employer City	Employer State
132–171	172–211	212–236	237–238

Employer Zip Code	Charged Tips	Charged Receipts	Service Charge Less Than 10 Percent
239–247	248–259	260–271	272–283

Indirect Tips Reported	Direct Tips Reported	Total Tips Reported	Gross Receipts
284–295	296–307	308–319	320–331

Tip Percentage Rate Times Gross Receipts	Tip Percentage Rate	Allocated Tips	Allocation Method
332–343	344–347	348–359	360

Number of Directly Tipped Employees	Transmitter Control Code (TCC)	Corrected 8027 Indicator	Blank or cr/lf
361–364	365–369	370	371–372

SEC. 8. EFFECT ON OTHER DOCUMENTS

.01 Rev. Proc. 92-81 is superseded.

SEC. 9. EFFECTIVE DATE

.01 This revenue procedure is effective for Forms 8027 due the last day of February 1999 and any returns filed thereafter.

I R B
Special Projects
Box _____ of _____

I R B
Special Projects
Box _____ of _____

I R B
Special Projects
Box _____ of _____

I R B
Special Projects
Box _____ of _____

I R B
Special Projects
Box _____ of _____

I R B
Special Projects
Box _____ of _____

Internal Revenue Service
Martinsburg Computing Center
Special Projects
P O Box 1359
Martinsburg WV 25402

(use this label for U S Postal deliveries)

Internal Revenue Service
Martinsburg Computing Center
Special Projects
Route 9 and Needy Road
Martinsburg WV 25401

(use this label for truck or air freight deliveries)

(Reproduce as needed)

To expedite handling, please affix this label, or a substitute label, to your OUTSIDE shipping container.

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Qualified State Tuition Programs

REG–106177–97

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to qualified State tuition programs (QSTPs). These proposed regulations reflect changes to the law made by the Small Business Job Protection Act of 1996 and the Taxpayer Relief Act of 1997. The proposed regulations affect QSTPs established and maintained by a State or agency or instrumentality of a State, and individuals receiving distributions from QSTPs. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by November 23, 1998. Outlines of topics to be discussed at the public hearing scheduled for Wednesday, January 6, 1999, at 10 a.m. must be received by December 16, 1998.

ADDRESSES: Send submissions to CC:DOM:CORP:R (REG–106177–97), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–106177–97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Monice Rosenbaum, (202) 622-6070; concerning the proposed estate and gift tax regulations, Susan Hurwitz (202) 622-3090; concerning submissions and the hearing, Michael Slaughter, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget,** Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington DC 20503, with copies to the **Internal Revenue Service,** Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224. Comments on the collection of information should be received by October 23, 1998. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the **Internal Revenue Service,** including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information;

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase or services to provide information.

The collection of information in this proposed regulation is in §§1.529–2(e)(4), 1.529–2(f) and (i), 1.529–4, and 1.529–5(b)(2). This information is required by the IRS to verify compliance with sections 529(b)(3), (4), (7) and (d). This information will be used by the IRS and individuals receiving distributions from QSTPs to determine that the taxable amount of the distribution has been computed correctly. The collection of information is required to obtain the benefit of being a QSTP described in section 529. The likely respondents and/or recordkeepers are state governments and distributees who receive distributions under the programs. The burden for reporting distributions is reflected in the burden for Form 1099–G, Certain Government Payments. The burden for electing to take certain contributions to a QSTP into account ratably over a five year period in determining the amount of gifts made during the calendar year is reflected in the burden for Form 709, Federal Gift Tax Return.

Estimated total annual reporting/recordkeeping burden: 705,000 hours

Estimated average annual burden per respondent/recordkeeper: 35 hours, 10 minutes

Estimated number of respondents/recordkeepers: 20,051

Estimated annual frequency of responses: On occasion

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) relating to qualified State tuition programs described in section 529. Section 529 was added to the Internal Revenue Code by section 1806 of the Small Business Job Protection Act of 1996, Public Law 104–188, 110 Stat. 1895. Section 529 was modified by sections 211 and 1601(h) of the Taxpayer Relief Act of 1997, Public Law 105–34, 111 Stat. 810 and 1092.

Section 529 provides tax-exempt status to qualified State tuition programs (QSTPs) established and maintained by a State (or agency or instrumentality

thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary entitling the beneficiary to a waiver or payment of qualified higher education expenses, or (2) contribute to an account established exclusively for the purpose of meeting qualified higher education expenses of the designated beneficiary. Qualified higher education expenses, for purposes of section 529, are tuition, fees, books, supplies, and equipment required for enrollment or attendance at an eligible educational institution, as well as certain room and board expenses for students who attend an eligible educational institution at least half-time. An eligible educational institution is an accredited post-secondary educational institution offering credit toward a bachelor's degree, an associate's degree, a graduate-level or professional degree, or another recognized post-secondary credential. The institution must be eligible to participate in Department of Education student aid programs.

QSTPs established and maintained by a State (or agency or instrumentality thereof) must require all contributions to the program be made only in cash. Neither contributors nor designated beneficiaries may direct the investment of any contributions or any earnings on contributions. No interest in the program may be pledged as security for a loan. A separate accounting must be provided to each designated beneficiary in the program. A program must impose a more than de minimis penalty on refunds that are not used for qualified higher education expenses, not made on account of death or disability of the designated beneficiary, or not made on account of a scholarship or certain other educational allowances. A program must provide adequate safeguards to prevent contributions in excess of those necessary to provide for the qualified higher education expenses of the beneficiary. A specified individual must be designated as the beneficiary at the commencement of participation in a QSTP, unless the interests in the program are purchased by a State or local government or a tax-exempt organization described in section 501(c)(3) as part of a scholarship program operated by such government or organization under which beneficiaries to be named in the future will receive the interests as scholarships.

Distributions under a QSTP are includible in the gross income of the distributee in the manner as provided under section 72 to the extent not excluded from gross income under any other provision. Distributions include in-kind benefits furnished to a designated beneficiary under a QSTP. Any distribution, or portion of a distribution, that is transferred within 60 days under a QSTP to the credit of a new designated beneficiary who is a member of the family of the old designated beneficiary shall not be treated as a distribution. A change in the designated beneficiary of an interest in a QSTP shall not be treated as a distribution if the new beneficiary is a member of the family of the old beneficiary. A member of the family means the spouse of the designated beneficiary or an individual who is related to the designated beneficiary as described in section 152(a)(1) through (8) or is the spouse of any of these individuals.

Section 529, as added to the Code by the Small Business Job Protection Act of 1996 (1996 Act), contained provisions addressing the estate, gift, and generation-skipping transfer tax. The provisions were significantly revised, effective prospectively, by the Taxpayer Relief Act of 1997 (1997 Act).

A contribution on behalf of a designated beneficiary to a QSTP which is made after August 20, 1996, and before August 6, 1997, is not treated as a taxable gift. Rather, the subsequent waiver (or payment) of qualified higher education expenses of a designated beneficiary by (or to) an educational institution under the QSTP is treated as a qualified transfer under section 2503(e) and is not treated as a transfer of property by gift for purposes of section 2501. As such, the contribution is not subject to the generation-skipping transfer tax imposed by section 2601.

In contrast, under section 529 as amended by the 1997 Act, a contribution on behalf of a designated beneficiary to a QSTP after August 5, 1997, is a completed gift of a present interest in property under section 2503(b) from the contributor to the designated beneficiary and is not a qualified transfer within themeaning of section 2503(e). The portion of a contribution excludible from taxable gifts under section 2503(b) also satisfies the requirements of section 2642(c)(2) and, therefore, is also excludible for purposes of the generation-skipping transfer tax imposed under section 2601. For purposes of the annual exclusion, a contributor may elect to take certain contributions to a QSTP into account ratably over a five-year period in determining the amount of gifts made during the calendar year. Under section 529 as amended by the 1997 Act, a transfer which occurs by reason of a change in the designated beneficiary of a QSTP, or a rollover from the account of one beneficiary to the account of another beneficiary in a QSTP, is not a taxable gift if the new beneficiary is a member of the family, as defined in section 529(e)(2), of the old beneficiary, and is assigned to the same generation, as defined in section 2651, as the old beneficiary. If the new beneficiary is assigned to a lower generation than the old beneficiary, the transfer is a taxable gift from the old beneficiary to the new beneficiary regardless of whether the new beneficiary is a member of the family of the old beneficiary. In addition, the transfer will be subject to the generation-skipping transfer tax if the new beneficiary is assigned to a generation which is two or more levels lower than the generation assignment of the old beneficiary. The five-year averaging election for purposes of the gift tax annual exclusion may be applied to the transfer.

Regarding the application of the estate tax, the value of any interest in any QSTP which is attributable to contributions made by a decedent who died after August 20, 1996, and before June 9, 1997, is includible in the decedent's gross estate. In contrast, pursuant to the 1997 Act amendments to section 529, the value of such an interest is not includible in the gross estate of a decedent who dies after June 8, 1997, unless the decedent had elected the five-year averaging rule for purposes of the gift tax annual exclusion and died before the close of the five-year period. In that case, the portion of the contribution allocable to calendar years beginning after the decedent's date of death is includible in his gross estate.

Also, pursuant to the 1997 Act amendments to section 529, the value of any interest in a QSTP held for a designated beneficiary who dies after June 8, 1997, is includible in the designated beneficiary's gross estate.

The Federal estate and gift tax treat-

ment of QSTP interests has no effect on the actual rights and obligations of the parties pursuant to the terms of the contracts under State law. In addition, the estate and gift tax treatment of contributions to a QSTP and interests in a QSTP is generally different from the treatment that would otherwise apply under generally applicable estate and gift tax principles. For example, under most contracts, the contributor may retain the right to change the designated beneficiary of an account, to designate any person other than the designated beneficiary to whom funds may be paid from the account, or to receive distributions from the account if no such other person is designated. Such rights would ordinarily cause the transfer to the account to fail to be a completed gift and mandate inclusion of the value of the undistributed interest in the QSTP in the gross estate of the contributor under sections 2036 and/or 2038. However, under section 529, the gross estate of a contributor who dies after June 8, 1997, does not include the value of any interest in a QSTP attributable to contributions from the contributor (except amounts attributable to calendar years after death where the five-year averaging rule has been elected). Also, because a contribution after August 5, 1997, is a completed gift from the contributor to the designated beneficiary, any subsequent transfer which occurs by reason of a change in the designated beneficiary or a rollover from the account of the original designated beneficiary to the account of another beneficiary is treated, to the extent it is subject to the gift and/or generation-skipping transfer tax, as a transfer from the original designated beneficiary to the new beneficiary. This is the result even though the change in beneficiary or the rollover is made at the direction of the contributor under the terms of the contract.

Comments from Notice 96–58

In Notice 96–58, 1996–2 C.B. 226, the Internal Revenue Service invited comments on section 529 including the requirements for reporting distributions by QSTPs, the requirements for qualification and operation of programs, and the treatment of distributions made by programs for federal tax purposes. Eighteen comments were received. The comments addressed a broad range of issues, including but not limited to, those outlined by Notice 96–58, the concept of account ownership and gift tax rules, enforcement of penalties, accounting and recordkeeping, and transition relief for programs in existence on August 20, 1996. The summary below is not intended to be a complete discussion of the comments. However, all matters presented in the comments were considered in the drafting of this notice of proposed rulemaking.

One commenter discussed in detail the requirements that a QSTP be "established and maintained" by a State or agency or instrumentality of a State. The commenter recommended a list of factors to be considered in determining whether a State maintains the program. This commenter and others urged that the use of outside contractors or the holding of program deposits at a private financial institution selected by the State not be determinative of whether the program was maintained by the State.

One commenter was endorsed by several others for suggesting two specific safe harbors to satisfy the requirement that a program impose more than a de minimis penalty on refunds. The first safe harbor was a 5 percent of earnings penalty on refunds of earnings prior to the designated beneficiary matriculating, reduced to at least a 1 percent penalty on refunds of earnings only after the age of matriculation. The second safe harbor was a fixed-rate safe harbor equal to the lesser of $50 or 1 percent of the assets distributed. Another commenter suggested an additional safe harbor based on the return of Series EE savings bonds. That commenter also suggested that safe harbors are not necessarily the minimum acceptable penalties and that all facts and circumstances should be taken into account in determining the adequacy of penalties that are less than the safe harbor penalties.

Commenters urged that regulations limit or avoid rules requiring programs to enforce penalties or require substantiation to ensure that disbursements are used to pay for qualified higher education expenses. Recognizing however that there may be some misuse in this area, commenters recommended that checks from QSTPs be marked with a special endorsement or be payable to both the educational institution and the designated beneficiary.

Commenters suggested that the prohibition on investment direction not include a choice between a prepaid tuition program and a savings program (established and maintained in one State), a choice among options in a prepaid tuition program, a choice among options for the initial contribution to the program, or an opportunity to change investment strategies. One commenter suggested that the prohibition on investment direction not apply to prevent participation in the program by program board and staff members.

Commenters suggested several approaches for satisfying the prohibition on excess contributions. Two safe harbors were proposed; one was based upon eight times the average annual undergraduate tuition and required fees at private four-year universities; the other was based upon five years of tuition, fees, books, supplies, and equipment at the highest cost institution allowed by the State's program. Other approaches proposed allowing the provision of adequate safeguards to prevent excess contributions to be left to the discretion of the program or allowing the contributor to certify that no attempt would be made to overfund the account.

Commenters made suggestions and raised concerns regarding: separate accounting rules including, but not limited to, the valuation and tracking of tuition units; the operating rules treating all programs in which an individual is a designated beneficiary as one program, and treating all distributions during a taxable year as one distribution; the application of section 72 to calculate distributions; and, income tax consequences relating to account ownership, penalties, and withholding.

The modifications made to section 529 by the Taxpayer Relief Act of 1997 have addressed, in large part, the issues raised by commenters concerning transition relief for programs in existence on August 20, 1996, estate and gift tax consequences for contributors and designated beneficiaries, and definitions pertaining to family members and eligible educational institutions.

Explanation of Provisions

Qualification as Qualified State Tuition Program (QSTP): Unrelated Business Income Tax and Filing Requirements

The proposed regulations provide guidance on the requirements a program must

satisfy in order to be a QSTP described in section 529. A program that meets these requirements generally is exempt from income taxation. However, a QSTP is subject to the taxes imposed by section 511 relating to imposition of tax on unrelated business income. For purposes of section 529 and these regulations, an interest in a QSTP shall not be treated as debt for purposes of section 514; consequently, investment income earned on contributions to the program by purchasers will not constitute debt-financed income subject to the unrelated business income tax. However, investment income of the QSTP shall be subject to the unrelated business income tax to the extent the program incurs indebtedness when acquiring or improving income-producing property. Earnings forfeited on educational contracts or savings, amounts collected as penalties on refunds or excess contributions, and certain administrative and other fees are not unrelated business income to the QSTP. A QSTP is not required to file Form 990, Return of Organization Exempt From Income Tax, however, this does not affect the obligation of a QSTP to file Form 990–T, Exempt Organization Business Income Tax Return.

Established and Maintained

The proposed regulations provide that a program is established by a State or agency or instrumentality of the State if the program is initiated by State statute or regulation, or by an act of a State official or agency with the authority to act on behalf of the State. A program is maintained by a State or agency or instrumentality of a State if all the terms and conditions of the program are set by the State or agency or instrumentality and the State or agency or instrumentality is actively involved on an ongoing basis in the administration of the program, including supervising all decisions relating to the investment of assets contributed to the program. The proposed regulations set forth factors that are relevant in determining whether a State, agency or instrumentality is actively involved in the administration of the program. Included in the factors is the manner and extent to which it is permissible for the program to contract out for professional and financial services.

Penalties and Substantiation – Safe Harbors

As required by section 529(b)(3), a more than de minimis penalty must be imposed on the earnings portion of any distribution from the program that is not used for the qualified higher education expenses of the designated beneficiary, not made on account of the death or disability of the designated beneficiary, or not made on account of a scholarship or certain other payments described in sections 135(d)(1)(B) and (C) that are received by the designated beneficiary to the extent the amount of the refund does not exceed the amount of the scholarship, allowance, or payment. The penalty shall also not apply to rollover distributions described in section 529(c)(3)(C) which are discussed in the section titled *Income Tax Treatment of Distributees,* below. The proposed regulations provide that a penalty is more than de minimis if it is consistent with a program intended to assist individuals in saving exclusively for qualified higher education expenses. Whether any penalty is more than de minimis will depend upon the facts and circumstance of the particular program, including the extent to which the penalty offsets the federal income tax benefit from having deferred income tax liability on the earnings portion of any distribution. The proposed regulations provide a safe harbor penalty that a program may adopt for satisfying this requirement. For purposes of the safe harbor, a penalty imposed on the earnings portion of a distribution is more than de minimis if it is equal to or greater than 10 percent of the earnings.

To be treated as imposing a more than de minimis penalty as required by section 529(b)(3) a program must implement practices and procedures for identifying whether a distribution is subject to a penalty and collecting any penalty that is due. The proposed regulations, in the form of a safe harbor, set forth practices and procedures that may be implemented by a program. The safe harbor provides that distributions are treated as payments of qualified higher education expenses if the distribution is made directly to an eligible educational institution; the distribution is made in the form of a check payable to both the designated beneficiary and the eligible educational institution; the distribution is made after the designated beneficiary submits substantiation showing that the qualified higher education expenses were paid and the program reviews the substantiation; or the designated beneficiary certifies prior to distribution the amount to be used for qualified higher education expenses and the program requires substantiation of payment within 30 days of making the distribution, the program reviews the substantiation, and the program retains an amount necessary to collect the penalty owed on the distribution if valid substantiation is not produced.

The safe harbor procedure provides that a penalty be collected on all other distributions except where prior to distribution the program receives written third party confirmation that the designated beneficiary has died or become disabled or has received a scholarship or allowance or payment described in section 135(d)(1)(B) or (C). Alternatively, distributions may be made upon the certification of the account owner that the designated beneficiary has died or become disabled or has received a scholarship or allowance or payment described above, if the program withholds a portion of the distribution as a penalty. The penalty may be refunded after receipt of third party confirmation of the certification made by the account owner.

The safe harbor procedure provides that a program may document amounts refunded from eligible educational institutions that were not used for qualified higher education expenses by requiring a signed written statement from the distributee identifying the amount of any refund received from an eligible educational institution at the end of each year in which distributions for qualified higher education expenses were made and of the next year. A program must also have procedures to collect the penalty either by retaining a sufficient balance in the account to pay the penalty, withholding an amount equal to the penalty from a distribution, or collecting the penalty on a State income tax return.

Other Requirements for QSTP Qualification

As described in section 529(b)(1)(A), the proposed regulations provide that con-

tributions to the program can be placed into either a prepaid educational arrangement or contract, or an educational savings account, or both, but cannot be placed into any other type of account. Contributions may be made only in cash and not in property as provided in section 529(b)(2), however, the proposed regulations provide that a program may accept payment in cash, or by check, money order, credit card, or similar methods.

Section 529(b)(4) requires that a program provide separate accounting for each designated beneficiary. Separate accounting requires that contributions for the benefit of a designated beneficiary and earning attributable to those contributions are allocated to the appropriate account. The proposed regulations provide that if a program does not ordinarily provide each account owner an annual account statement showing the transactions related to the account, the program must give this information to the account owner or designated beneficiary upon request.

Section 529(b)(5) states that a program shall not be treated as a QSTP unless it provides that any contributor to, or designated beneficiary under, such program may not directly or indirectly direct the investment of any contributions to the program or any earnings thereon. A program will not violate the requirement of this paragraph if it permits a person who establishes an account to select between a prepaid educational services account and an educational savings account, or to select among different investment strategies designed exclusively by the program, at the time that an educational savings account is established. However, the proposed regulations clarify that a program will violate this requirement if, after an account with the program initially is established, the account owner, a contributor, or the designated beneficiary subsequently is permitted to select among different investment options or strategies. A program will not violate this requirement merely because it permits its board members, its employees, or the board members or employees of a contractor it hires to perform administrative services to purchase tuition credits or certificates or make contributions.

Section 529(b)(6) provides that a program may not allow any interest in the program, or any portion of an interest in the program, to be used as security for a loan. The proposed regulations clarify that this restriction includes, but is not limited to, a prohibition on the use of any interest in the program as security for a loan used to purchase the interest in the program.

Section 529(b)(7) requires a program to establish adequate safeguards to prevent contributions for the benefit of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the designated beneficiary. The proposed regulations provide a safe harbor that permits a program to satisfy this requirement if the program will bar any additional contributions to an account as soon as the account reaches a specified limit applicable to all accounts of designated beneficiaries with the same expected year of enrollment. The total contributions may not exceed the amount determined by actuarial estimates that is necessary to pay tuition, required fees, and room and board expenses of the designated beneficiary for five years of undergraduate enrollment at the highest cost institution allowed by the program. The safe harbor in the proposed regulations applies only to the program. Despite the fact that a program has met the safe harbor, a particular account established under the program may have a balance that exceeds the amount actually needed to cover the particular designated beneficiary's qualified higher education expenses. Distributions made that are not used for qualified higher education expenses of the designated beneficiary are subject to the penalty provisions of section 529(b)(3).

Income Tax Treatment of Distributees

In accordance with section 529(c)(3), the proposed regulations provide that distributions made by a QSTP, including any benefit furnished in-kind, must be included in the gross income of the distributee to the extent that the distribution consists of earnings. The proposed regulations clarify that term "distributee" refers to the designated beneficiary or the account owner who receives or is treated as receiving a distribution from a QSTP. As required by section 529(c)(3)(A), distributions under a QSTP must be included in income in the manner as provided under section 72. Therefore, deposits or contributions made into an account under a QSTP are recovered ratably over the period of time distributions are made. The amount of taxable earnings shall be determined by applying an earnings ratio, generally the earnings allocable to the account as of the close of the calendar year divided by the total account balance as of the close of the calendar year, to the distribution. In the case of a prepaid educational services account, this method of calculating taxable earnings utilizes an average value for each unit of education (e.g., credit, hour, semester, or other unit of education) that is distributed rather than the recovery of the cost of any particular unit of education.

In accordance with section 529(c)(3)-(C), the proposed regulations permit nontaxable rollover distributions. A rollover consists of a distribution or transfer from an account of a designated beneficiary that is transferred to or deposited within 60 days of the distribution into an account of another individual who is a member of the family of the designated beneficiary. A distribution is not a rollover distribution unless there is a change in beneficiary. The new designated beneficiary's account may be in a QSTP established or maintained by the same State or by another State. A transfer from the designated beneficiary to himself or herself, regardless of whether the transfer is to an account within the same QSTP or another QSTP in the same or another State, is not a rollover distribution and is taxable under the general rule. The Internal Revenue Service is concerned about the use of multiple rollovers to circumvent the restriction on investment direction. In particular, the Internal Revenue Service requests comments on this issue, including whether limits should be placed on the number of rollovers permitted within a certain time period or rollovers back to the original designated beneficiary. No taxable distribution will result from a change in designated beneficiary of an interest in a QSTP purchased by a State or local government or an organization described in section 501(c)(3) as part of a scholarship program.

Reporting Requirements

The proposed regulations set forth recordkeeping and reporting require-

ments. A QSTP must maintain records that enable the program to produce an annual account balance for each account. See, requirements related to section 529(b)(4) above. A QSTP must report taxable earnings on Form 1099–G, Certain Government Payments, to distributees. Any reporting requirements promulgated under section 529(d) apply in lieu of any other reporting requirement for a program that may apply with respect to information returns or payee statements or distributions. The proposed regulations contain more detail on how the information must be reported.

Estate and Gift Tax

The proposed regulations provide guidance on the gift and generation-skipping transfer tax consequences of contributions to a QSTP, a change in the designated beneficiary of a QSTP, and a rollover from the account of one beneficiary to the account of another beneficiary under a QSTP. The proposed regulations also provide guidance on whether and to what extent the value of an interest in a QSTP is includible in the gross estate of a contributor to a QSTP or the gross estate of a designated beneficiary of a QSTP. Because of the amendments to section 529 made by the Taxpayer Relief Act of 1997, different gift tax rules apply to contributions made after August 20, 1996, and before August 6, 1997, than apply to contributions made after August 5, 1997. Also, estates of decedents dying after August 20, 1996, and before June 9, 1997, are treated differently from estates of decedents dying after June 8, 1997. Comments are requested specifically on whether there is a need for more detailed guidance with respect to the estate, gift, and generation-skipping transfer tax provisions.

Transition Rules

In accordance with section 1806(c) of the Small Business Job Protection Act of 1996 and section 1601(h) of the Taxpayer Relief Act of 1997, special transition rules apply to programs in existence on August 20, 1996. The proposed regulations provide that no income tax liability will be asserted against a QSTP for any period before the program meets the requirements of section 529 and these regulations if the program qualifies for the transition relief. A program shall be treated as meeting the transition rule if it conforms to the requirements of section 529 and these regulations by the date of final regulations.

The proposed regulations provide transition rules that grandfather certain provisions in contracts issued and accounts opened before August 20, 1996. These contracts may be honored without regard to the definitions of "member of the family" and "eligible educational institution" used in section 529(e)(2) and (3), and without regard to section 529(b)(6) which prohibits the pledging of a QSTP interest as security for a loan. However, regardless of the terms of any agreement executed before August 20, 1996, distributions made by the QSTP are subject to tax according to the rules of §1.529–3 and subject to the reporting requirements of §1.529–4.

Proposed Effective Date

These regulations are proposed to be effective on the date they are published in the **Federal Register** as final regulations. Taxpayers may, however, rely on the proposed regulations for taxable years ending after August 20, 1996. Programs that were in existence on August 20, 1996, may also rely upon the transition rules provided.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Wednesday, January 6, 1999, beginning at 10 a.m. in room 2615 of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by December 16, 1998.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these proposed regulations are Monice Rosenbaum, Office of Associate Chief Counsel (Employee Benefits and Exempt Organizations) and Susan Hurwitz, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805* * *

Par. 2. An undesignated center heading and §§1.529–0 through 1.529–6 are added to read as follows:

QUALIFIED STATE TUITION PROGRAMS

§1.529–0 Table of contents.

This section lists the following captions contained in §§1.529–1 through 1.529-–6:

§1.529–1 Qualified State tuition program, unrelated business income tax and definitions.

(a) In general.
(b) Unrelated business income tax rules.
(1) Application of section 514.
(2) Penalties and forfeitures.
(3) Administrative and other fees.
(c) Definitions.

§1.529–2 Qualified State tuition program described.

(a) In general.
(b) Established and maintained by a State or agency or instrumentality of a State.
(1) Established.
(2) Maintained.
(3) Actively involved.
(c) Permissible uses of contributions.
(d) Cash contributions.
(e) Penalties on refunds.
(1) General rule.
(2) More than de minimis penalty.
(i) In general.
(ii) Safe harbor.
(3) Separate distributions.
(4) Procedures for verifying use of distributions and imposing and collecting penalties.
(i) In general.
(ii) Safe harbor.
(A) Distributions treated as payments of qualified higher education expenses.
(B) Treatment of all other distributions.
(C) Refunds of penalties.
(D) Documentation of amounts refunded and not used for qualified higher education expenses.
(E) Procedures to collect penalty.
(f) Separate accounting.
(g) No investment direction.
(h) No pledging of interest as security.
(i) Prohibition on excess contributions.
(1) In general.
(2) Safe harbor.

§1.529–3 Income tax treatment of distributees.

(a) Taxation of distributions.
(1) In general.
(2) Rollover distributions.
(b) Computing taxable earnings.
(1) Amount of taxable earnings in a distribution.
(i) Educational savings account.
(ii) Prepaid educational services account.
(2) Adjustment for programs that treated distributions and earnings in a different manner for years beginning before January 1, 1999.
(3) Examples.
(c) Change in designated beneficiaries.
(1) General rule.
(2) Scholarship program.
(d) Aggregation of accounts.

§1.529–4 Time, form, and manner of reporting distributions from QSTPs and backup withholding.

(a) Taxable distributions.
(b) Requirement to file return.
(1) Form of return.
(2) Payor.
(3) Information included on return.
(4) Time and place for filing return.
(5) Returns required on magnetic media.
(6) Extension of time to file return.
(c) Requirement to furnish statement to the distributee.
(1) In general.
(2) Information included on statement.
(3) Time for furnishing statement.
(4) Extension of time to furnish statement.
(d) Backup withholding.
(e) Effective date.

§1.529–5 Estate, gift, and generation-skipping transfer tax rules relating to qualified State tuition programs.

(a) Gift and generation-skipping transfer tax treatment of contributions after August 20, 1996, and before August 6, 1997.
(b) Gift and generation-skipping transfer tax treatment of contributions after August 5, 1997.
(1) In general.
(2) Contributions that exceed the annual exclusion amount.
(3) Change of designated beneficiary or rollover.
(c) Estate tax treatment for estates of decedents dying after August 20, 1996, and before June 9, 1997.
(d) Estate tax treatment for estates of decedents dying after June 8, 1997.
(1) In general.
(2) Excess contributions.
(3) Designated beneficiary decedents.

§1.529–6 Transition rules.

(a) Effective date.
(b) Programs maintained on August 20, 1996.
(c) Retroactive effect.
(d) Contracts entered into and accounts opened before August 20, 1996.
(1) In general.
(2) Interest in program pledged as security for a loan.
(3) Member of the family.
(4) Eligible educational institution.

§1.529–1 Qualified State tuition program, unrelated business income tax and definitions.

(a) *In general.* A qualified State tuition program (QSTP) described in section 529 is exempt from income tax, except for the tax imposed under section 511 on the QSTP's unrelated business taxable income. A QSTP is not required to file Form 990, Return of Organization Exempt From Income Tax, Form 1041, U.S. Income Tax Return for Estates and Trusts, or Form 1120, U.S. Corporation Income Tax Return. A QSTP may be required to file Form 990–T, Exempt Organization Business Income Tax Return. See §§1.6012–2(e) and 1.6012–3(a)(5) for requirements for filing Form 990–T.

(b) *Unrelated business income tax rules.* For purposes of section 529, this section and §§1.529–2 through 1.529–6:

(1) *Application of section 514.* An interest in a QSTP shall not be treated as debt for purposes of section 514. Consequently, a QSTP's investment income will not constitute debt-financed income subject to the unrelated business income tax merely because the program accepts contributions and is obligated to pay out or refund such contributions and certain earnings attributable thereto to designated beneficiaries or to account owners. However, investment income of a QSTP shall be subject to the unrelated business income tax as debt-financed income to the extent the program incurs indebtedness when acquiring or improving income-producing property.

(2) *Penalties and forfeitures.* Earnings forfeited on prepaid educational arrange-

ments or contracts and educational savings accounts and retained by a QSTP, or amounts collected by a QSTP as penalties on refunds or excess contributions are not unrelated business income to the QSTP.

(3) *Administrative and other fees.* Amounts paid, in order to open or maintain prepaid educational arrangements or contracts and educational savings accounts, as administrative or maintenance fees, and other similar fees including late fees, service charges, and finance charges, are not unrelated business income to the QSTP.

(c) *Definitions.* For purposes of section 529, this section and §§1.529–2 through 1.529–6:

Account means the formal record of transactions relating to a particular designated beneficiary when it is used alone without further modification in these regulations. The term includes prepaid educational arrangements or contracts described in section 529(b)(1)(A)(i) and educational savings accounts described in section 529(b)(1)(A)(ii).

Account owner means the person who, under the terms of the QSTP or any contract setting forth the terms under which contributions may be made to an account for the benefit of a designated beneficiary, is entitled to select or change the designated beneficiary of an account, to designate any person other than the designated beneficiary to whom funds may be paid from the account, or to receive distributions from the account if no such other person is designated.

Contribution means any payment directly allocated to an account for the benefit of a designated beneficiary or used to pay late fees or administrative fees associated with the account. In the case of a tax-free *rollover,* within the meaning of this paragraph (c), into a QSTP account, only the portion of the rollover amount that constituted *investment in the account,* within the meaning of this paragraph (c), is treated as a contribution to the account as required by §1.529–3(a)(2).

Designated beneficiary means—

(1) The individual designated as the beneficiary of the account at the time an account is established with the QSTP;

(2) The individual who is designated as the new beneficiary when beneficiaries are changed; and

(3) The individual receiving the benefits accumulated in the account as a scholarship in the case of a QSTP account established by a State or local government or an organization described in section 501(c)(3) and exempt from taxation under section 501(a) as part of a scholarship program operated by such government or organization.

Distributee means the designated beneficiary or the account owner who receives or is treated as receiving a distribution from a QSTP. For example, if a QSTP makes a distribution directly to an eligible educational institution to pay tuition and fees for a designated beneficiary or a QSTP makes a distribution in the form of a check payable to both a designated beneficiary and an eligible educational institution, the distribution shall be treated as having been made in full to the designated beneficiary.

Distribution means any disbursement, whether in cash or in-kind, from a QSTP. Distributions include, but are not limited to, tuition credits or certificates, payment vouchers, tuition waivers or other similar items. Distributions also include, but are not limited to, a refund to the account owner, the designated beneficiary or the designated beneficiary's estate.

Earnings attributable to an account are the total account balance on a particular date minus the investment in the account as of that date.

Earnings ratio means the amount of earnings allocable to the account on the last day of the calendar year divided by the total account balance on the last day of that calendar year. The earnings ratio is applied to any distribution made during the calendar year. For purposes of computing the earnings ratio, the earnings allocable to the account on the last day of the calendar year and the total account balance on the last day of the calendar year include all distributions made during the calendar year and any amounts that have been forfeited from the account during the calendar year.

Eligible educational institution means an institution which is described in section 481 of the Higher Education Act of 1965 (20 U.S.C 1088) as in effect on August 5, 1997, and which is eligible to participate in a program under title IV of such Act. Such institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, a graduate level or professional degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible institutions. The institution must be eligible to participate in Department of Education student aid programs.

Final distribution means the distribution from a QSTP account that reduces the total account balance to zero.

Forfeit means that earnings and contributions allocable to a QSTP account are withdrawn by the QSTP from the account or deducted by the QSTP from a distribution to pay a penalty as required by §1.529–2(e).

Investment in the account means the sum of all contributions made to the account on or before a particular date less the aggregate amount of contributions included in distributions, if any, made from the account on or before that date.

Member of the family means an individual who is related to the designated beneficiary as described in paragraphs (1) through (9) of this definition. For purposes of determining who is a member of the family, a legally adopted child of an individual shall be treated as the child of such individual by blood. The terms brother and sister include a brother or sister by the halfblood. Member of the family means—

(1) A son or daughter, or a descendant of either;

(2) A stepson or stepdaughter;

(3) A brother, sister, stepbrother, or stepsister;

(4) The father or mother, or an ancestor of either;

(5) A stepfather or stepmother;

(6) A son or daughter of a brother or sister;

(7) A brother or sister of the father or mother;

(8) A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; or

(9) The spouse of the designated beneficiary or the spouse of any individual described in paragraphs (1) through (8) of this definition.

Person has the same meaning as under section 7701(a)(1).

Qualified higher education expenses means —

(1) Tuition, fees, and the costs of books, supplies, and equipment required

for the enrollment or attendance of a designated beneficiary at an eligible educational institution; and

(2) The costs of room and board (as limited by paragraph (2)(i) of this definition) of a designated beneficiary (who meets requirements of paragraph (2)(ii) of this definition) incurred while attending an eligible educational institution:

(i) The amount of room and board treated as qualified higher education expenses shall not exceed the minimum room and board allowance determined in calculating costs of attendance for Federal financial aid programs under section 472 of the Higher Education Act of 1965 (20 U.S.C. 1087ll) as in effect on August 5, 1997. For purposes of these regulations, room and board costs shall not exceed $1,500 per academic year for a designated beneficiary residing at home with parents or guardians. For a designated beneficiary residing in institutionally owned or operated housing, room and board costs shall not exceed the amount normally assessed most residents for room and board at the institution. For all other designated beneficiaries the amount shall not exceed $2,500 per academic year. For this purpose the term academic year has the same meaning as that term is given in 20 U.S.C. 1088(d) as in effect on August 5, 1997.

(ii) Room and board shall be treated as qualified higher education expenses for a designated beneficiary if they are incurred during any academic period during which the designated beneficiary is enrolled or accepted for enrollment in a degree, certificate, or other program (including a program of study abroad approved for credit by the eligible educational institution) that leads to a recognized educational credential awarded by an eligible educational institution. In addition, the designated beneficiary must be enrolled at least half-time. A student will be considered to be enrolled at least half-time if the student is enrolled for at least half the full-time academic workload for the course of study the student is pursuing as determined under the standards of the institution where the student is enrolled. The institution's standard for a full-time workload must equal or exceed the standard established by the Department of Education under the Higher Education Act and set forth in 34 CFR 674.2(b).

Rollover distribution means a distribution or transfer from an account of a designated beneficiary that is transferred to or deposited within 60 days of the distribution into an account of another individual who is a member of the family of the designated beneficiary. A distribution is not a rollover distribution unless there is a change in beneficiary. The new designated beneficiary's account may be in a QSTP in either the same State or a QSTP in another State.

Total account balance means the total amount or the total fair market value of tuition credits or certificates or similar benefits allocable to the account on a particular date. For purposes of computing the *earnings ratio,* the total account balance is adjusted as described in this paragraph (c).

§1.529–2 Qualified State tuition program described.

(a) *In general.* To be a QSTP, a program must satisfy the requirements described in paragraphs (a) through (i) of this section. A QSTP is a program established and maintained by a State or an agency or instrumentality of a State under which a person—

(1) May purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary; or

(2) May make contributions to an account that is established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account.

(b) *Established and maintained by a State or agency or instrumentality of a State*—(1) *Established.* A program is established by a State or an agency or instrumentality of a State if the program is initiated by State statute or regulation, or by an act of a State official or agency with the authority to act on behalf of the State.

(2) *Maintained.* A program is maintained by a State or an agency or instrumentality of a State if—

(i) The State or agency or instrumentality sets all of the terms and conditions of the program, including but not limited to who may contribute to the program, who may be a designated beneficiary of the program, what benefits the program may provide, when penalties will apply to refunds and what those penalties will be; and

(ii) The State or agency or instrumentality is actively involved on an ongoing basis in the administration of the program, including supervising all decisions relating to the investment of assets contributed to the program.

(3) *Actively involved.* Factors that are relevant in determining whether a State, agency or instrumentality is actively involved include, but are not limited to: whether the State provides services or benefits (such as tax, student aid or other financial benefits) to account owners or designated beneficiaries that are not provided to persons who are not account owners or designated beneficiaries; whether the State or agency or instrumentality establishes detailed operating rules for administering the program; whether officials of the State or agency or instrumentality play a substantial role in the operation of the program, including selecting, supervising, monitoring, auditing, and terminating any private contractors that provide services under the program; whether the State or agency or instrumentality holds the private contractors that provide services under the program to the same standards and requirements that apply when private contractors handle funds that belong to the State or provide services to the State; whether the State provides funding for the program; and, whether the State or agency or instrumentality acts as trustee or holds program assets directly or for the benefit of the account owners or designated beneficiaries. If the State or an agency or instrumentality thereof exercises the same authority over the funds invested in the program as it does over the investments in or pool of funds of a State employees' defined benefit pension plan, then the State or agency or instrumentality will be considered actively involved on an ongoing basis in the administration of the program.

(c) *Permissible uses of contributions.* Contributions to a QSTP can be placed into either a prepaid educational arrangement or contract described in section 529(b)(1)(A)(i) or an educational savings account described in section 529(b)(1)-(A)(ii), or both, but cannot be placed into any other type of account.

(1) A prepaid educational services arrangement or contract is an account through which tuition credits or certificates or other rights are acquired that entitle the designated beneficiary of the account to the waiver or payment of qualified higher education expenses.

(2) An educational savings account is an account that is established exclusively for the purpose of meeting the qualified higher education expenses of a designated beneficiary.

(d) *Cash contributions.* A program shall not be treated as a QSTP unless it provides that contributions may be made only in cash and not in property. A QSTP may accept payment, however, in cash, or by check, money order, credit card, or similar methods.

(e) *Penalties on refunds*—(1) *General rule.* A program shall not be treated as a QSTP unless it imposes a more than de minimis penalty on the earnings portion of any distribution from the program that is not—

(i) Used exclusively for qualified higher education expenses of the designated beneficiary;

(ii) Made on account of the death or disability of the designated beneficiary;

(iii) Made on account of the receipt of a scholarship (or allowance or payment described in section 135(d)(1)(B) or (C)) by the designated beneficiary to the extent the amount of the distribution does not exceed the amount of the scholarship, allowance, or payment; or

(iv) A rollover distribution.

(2) *More than de minimis penalty*—(i) *In general.* A penalty is more than *de minimis* if it is consistent with a program intended to assist individuals in saving exclusively for qualified higher education expenses. Except as provided in paragraph (e)(2)(ii) of this section, whether any particular penalty is more than *de minimis* depends on the facts and circumstances of the particular program, including the extent to which the penalty offsets the federal income tax benefit from having deferred income tax liability on the earnings portion of any distribution.

(ii) *Safe harbor.* A penalty imposed on the earnings portion of a distribution is more than *de minimis* if it is equal to or greater than 10 percent of the earnings.

(3) *Separate distributions.* For purposes of applying the penalty, any single distribution described in paragraph (e)(1) of this section will be treated as a separate distribution and not part of a single aggregated annual distribution by the program, notwithstanding the rules under §1.529–3 and §1.529–4.

(4) *Procedures for verifying use of distributions and imposing and collecting penalties*—(i) *In general.* To be treated as imposing a more than de minimis penalty as required in paragraph (e)(1) of this section, a program must implement practices and procedures to identify whether a distribution is subject to a penalty and collect any penalty that is due.

(ii) *Safe harbor.* A program that falls within the safe harbor described in paragraphs (e)(4)(ii)(A) through (E) of this section will be treated as implementing practices and procedures to identify whether a more than de minimis penalty must be imposed as required in paragraph (e)(1) of this section.

(A) *Distributions treated as payments of qualified higher education expenses.* The program treats distributions as being used to pay for qualified higher education expenses only if—

(*1*) The distribution is made directly to an eligible educational institution;

(*2*) The distribution is made in the form of a check payable to both the designated beneficiary and the eligible educational institution;

(*3*) The distribution is made after the designated beneficiary submits substantiation to show that the distribution is a reimbursement for qualified higher education expenses that the designated beneficiary has already paid and the program has a process for reviewing the validity of the substantiation prior to the distribution; or

(*4*) The designated beneficiary certifies prior to the distribution that the distribution will be expended for his or her qualified higher education expenses within a reasonable time after the distribution; the program requires the designated beneficiary to provide substantiation of payment of qualified higher education expenses within 30 days after making the distribution and has a process for reviewing the substantiation; and the program retains an account balance that is large enough to collect any penalty owed on the distribution if valid substantiation is not produced.

(B) *Treatment of all other distributions.* The program collects a penalty on all distributions not treated as made to pay qualified higher education expenses except where—

(*1*) Prior to the distribution the program receives written third party confirmation that the designated beneficiary has died or become disabled or has received a scholarship (or allowance or payment described in section 135(d)(1)(B) or (C)) in an amount equal to the distribution; or

(*2*) Prior to the distribution the program receives a certification from the account owner that the distribution is being made because the designated beneficiary has died or become disabled or has received a scholarship (or allowance or payment described in section 135(d)(1)(B) or (C)) received by the designated beneficiary (and the distribution is equal to the amount of the scholarship, allowance, or payment) and the program withholds and reserves a portion of the distribution as a penalty. Any penalty withheld by the program may be refunded after the program receives third party confirmation that the designated beneficiary has died or become disabled or has received a scholarship or allowance (or payment described in section 135(d)(1)(B) or (C)).

(C) *Refunds of penalties.* The program will refund a penalty collected on a distribution only after the designated beneficiary substantiates that he or she had qualified higher education expenses greater than or equal to the distribution, and the program has reviewed the substantiation.

(D) *Documentation of amounts refunded and not used for qualified higher education expenses.* The program requires the distributee, defined in §1.529–1(c), to provide a signed statement identifying the amount of any refunds received from eligible educational institutions at the end of each year in which distributions for qualified higher education expenses were made and of the next year.

(E) *Procedures to collect penalty.* The program collects required penalties by retaining a sufficient balance in the account to pay the amount of penalty, withholding an amount equal to the penalty from a distribution, or collecting the penalty on a State income tax return.

(f) *Separate accounting.* A program shall not be treated as a QSTP unless it provides separate accounting for each

designated beneficiary. Separate accounting requires that contributions for the benefit of a designated beneficiary and any earnings attributable thereto must be allocated to the appropriate account. If a program does not ordinarily provide each account owner an annual account statement showing the total account balance, the investment in the account, earnings, and distributions from the account, the program must give this information to the account owner or designated beneficiary upon request. In the case of a prepaid educational arrangement or contract described in section 529(b)(1)(A)(i) the total account balance may be shown as credits or units of benefits instead of fair market value.

(g) *No investment direction.* A program shall not be treated as a QSTP unless it provides that any account owner in, or contributor to, or designated beneficiary under, such program may not directly or indirectly direct the investment of any contribution to the program or directly or indirectly direct the investment of any earnings attributable to contributions. A program does not violate this requirement if a person who establishes an account with the program is permitted to select among different investment strategies designed exclusively by the program, only at the time the initial contribution is made establishing the account. A program will not violate the requirement of this paragraph (g) if it permits a person who establishes an account to select between a prepaid educational services account and an educational savings account. A program also will not violate the requirement of this paragraph (g) merely because it permits its board members, its employees, or the board members or employees of a contractor it hires to perform administrative services to purchase tuition credits or certificates or make contributions as described in paragraph (c) of this section.

(h) *No pledging of interest as security.* A program shall not be treated as a QSTP unless the terms of the program or a state statute or regulation that governs the program prohibit any interest in the program or any portion thereof from being used as security for a loan. This restriction includes, but is not limited to, a prohibition on the use of any interest in the program as security for a loan used to purchase such interest in the program.

(i) *Prohibition on excess contributions*—(1) *In general.* A program shall not be treated as a QSTP unless it provides adequate safeguards to prevent contributions for the benefit of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the designated beneficiary.

(2) *Safe harbor.* A program satisfies this requirement if it will bar any additional contributions to an account as soon as the account reaches a specified account balance limit applicable to all accounts of designated beneficiaries with the same expected year of enrollment. The total contributions may not exceed the amount determined by actuarial estimates that is necessary to pay tuition, required fees, and room and board expenses of the designated beneficiary for five years of undergraduate enrollment at the highest cost institution allowed by the program.

§1.529–3 Income tax treatment of distributees.

(a) *Taxation of distributions*—(1) *In general.* Any distribution, other than a rollover distribution, from a QSTP account must be included in the gross income of the distributee to the extent of the earnings portion of the distribution and to the extent not excluded from gross income under any other provision of chapter 1 of the Internal Revenue Code. If any amount of a distribution is forfeited under a QSTP as required by §1.529–2(e), this amount is neither included in the gross income of the distributee nor deductible by the distributee.

(2) *Rollover distributions.* No part of a rollover distribution is included in the income of the distributee. Following the rollover distribution, that portion of the rollover amount that constituted investment in the account, defined in §1.529–1(c), of the account from which the distribution was made is added to the investment in the account of the account that received the distribution. That portion of the rollover amount that constituted earnings of the account that made the distribution is added to the earnings of the account that received the distribution.

(b) *Computing taxable earnings*—(1) *Amount of taxable earnings in a distribution*—(i) *Educational savings account.* In the case of an educational savings account, the earnings portion of a distribution is equal to the product of the amount of the distribution and the earnings ratio, defined in §1.529–1(c). The return of investment portion of the distribution is equal to the amount of the distribution minus the earnings portion of the distribution.

(ii) *Prepaid educational services account.* In the case of a prepaid educational services account, the earnings portion of a distribution is equal to the value of the credits, hours, or other units of education distributed at the time of distribution minus the return of investment portion of the distribution. The value of the credits, hours, or other units of education may be based on the tuition waived or the cash distributed. The return of investment portion of the distribution is determined by dividing the investment in the account at the end of the year in which the distribution is made by the number of credits, hours, or other units of education in the account at the end of the calendar year (including all credits, hours, or other units of education distributed during the calendar year), and multiplying that amount by the number of credits, hours, or other units of education distributed during the current calendar year.

(2) *Adjustment for programs that treated distributions and earnings in a different manner for years beginning before January 1, 1999.* For calendar years beginning after December 31, 1998, a QSTP must treat taxpayers as recovering investment in the account and earnings ratably with each distribution. Prior to January 1, 1999, a program may have treated distributions in a different manner and reported them to taxpayers accordingly. In order to adjust to the method described in this section, if distributions were treated as coming first from the investment in the account, the QSTP must adjust the investment in the account by subtracting the amount of the investment in the account previously treated as distributed. If distributions were treated as coming first from earnings, the QSTP must adjust the earnings portion of the account by subtracting the amount of earnings previously treated as distributed. After the adjustment is made, the investment in the account is recovered ratably in accordance with this section. If no previous distribution was made but earnings were treated as taxable to the taxpayer in

the year they were allocated to the account, the earnings treated as already taxable are treated as additional contributions and added to the investment in the account.

(3) *Examples.* The application of this paragraph (b) is illustrated by the following examples. The rounding convention used (rounding to three decimal places) in these examples is for purposes of illustration only. A QSTP may use another rounding convention as long as it consistently applies the convention. The examples are as follows:

Example 1. (i) In 1998, an individual, A, opens a prepaid educational services account with a QSTP on behalf of a designated beneficiary. Through the account A purchases units of education equivalent to eight semesters of tuition for full-time attendance at a public four-year university covered by the QSTP. A contributes $16,000 that includes payment of processing fees to the QSTP. In 2011 the designated beneficiary enrolls at a public four-year university. The QSTP makes distributions on behalf of the designated beneficiary to the university in August for the fall semester and in December for the spring semester. Tuition for full-time attendance at the university is $7,500 per academic year in 2011 and 2012, $7,875 for the academic year in 2013, and $8,200 for the academic year in 2014. The only expense covered by the QSTP distribution is tuition for four academic years. The calculations are as follows:

2011

Investment in the account as of 12/31/2011	=	$16,000
Units in account	=	8
Per unit investment	=	$ 2,000
Units distributed in 2011	=	2
Investment portion of distribution in 2011 ($2,000 per unit × 2 units)	=	$ 4,000
Current value of two units distributed in 2011	=	$ 7,500
Earnings portion of distribution in 2011 ($7,500 - $4,000)	=	$ 3,500

2012

Investment in the account as of 12/31/2012 ($16,000–$4,000)	=	$12,000
Units in account	=	6
Per unit investment	=	$ 2,000
Units distributed in 2012	=	2
Investment portion of distribution in 2012 ($2,000 per unit × 2 units)	=	$ 4,000
Current value of two units distributed in 2012	=	$ 7,500
Earnings portion of distribution in 2012 ($7,500–$4,000)	=	$ 3,500

2013

Investment in the account as of 12/31/2013 ($12,000–$4000)	=	$ 8,000
Units in account	=	4
Per unit investment	=	$ 2,000
Units distributed in 2013	=	2
Investment portion of distribution in 2013 ($2,000 per unit × 2 units)	=	$ 4,000
Current value of two units distributed in 2013	=	$ 7,875
Earnings portion of distribution in 2013 ($7,875–$4,000)	=	$ 3,875

2014

Investment in the account as of 12/31/2014 ($8,000–$4000)	=	$ 4,000
Units in account	=	2
Per unit investment	=	$ 2,000
Units distributed in 2014	=	2
Investment portion of distribution in 2014 ($4,000 per unit × 2 units)	=	$ 4,000
Current value of two units distributed in 2014	=	$ 8,200
Earnings portion of distribution in 2014 ($8,200–$4,000)	=	$ 4,200

12/31/2014 (after distributions)

Investment in the account as of 12/31/2014 ($4,000–$4000)	=	0

(ii) In each year the designated beneficiary includes in his or her gross income the earnings portion of the distribution for tuition.

Example 2. (i) In 1998, an individual, B, opens a college savings account with a QSTP on behalf of a designated beneficiary. B contributes $18,000 to the account that includes payment of processing fees to the QSTP. On December 31, 2011, the total balance in the account for the benefit of the designated beneficiary is $30,000 (including distributions made during the year 2011). In 2011 the designated beneficiary enrolls at a four-year university. The QSTP makes distributions on behalf of the designated beneficiary to the university in August for the fall semester and in December for the spring semester. Tuition for full-time attendance at the university is $7,500 per academic year in 2011 and 2012, $7,875 for the academic year in 2013, and $8,200 for the academic year in 2014. The only expense covered by the QSTP distributions is tuition for four academic years. On the last day of the calendar year the account is allocated earnings of 5% on the total account balance on that day. Under the terms of the QSTP, a penalty of 15% is applied to the earnings not used to pay tuition. The calculations are as follows:

2011

Investment in the account	=	$18,000
Total account balance as of 12/31/2011	=	$30,000
Earnings as of 12/31/2011	=	$12,000
Distributions in 2011	=	$ 7,500
Earnings ratio for 2011 ($12,000 ÷ $30,000)	=	40%
Earnings portion of distributions in 2011 ($7,500 × .4)	=	$ 3,000
Return of investment portion of distributions in 2011 ($7,500–$3,000)	=	$ 4,500

2012

Investment in the account as of 12/31/2012 ($18,000–$4,500)	=	$13,500
Total account balance as of 12/31/12 [($30,000–$7,500) × 105%]	=	$23,625
Earnings as of 12/31/2012	=	$10,125
Distributions in 2012	=	$ 7,500
Earnings ratio for 2012 ($10,125 ÷ $23,625)	=	42.9%
Earnings portion of distributions in 2012 ($7,500 × .429)	=	$ 3,217.50
Return of investment portion of distributions in 2012 ($7,500–$3,217.50)	=	$ 4,282.50

2013

Investment in the account as of 12/31/2013 ($13,500–$4,282.50)	=	$ 9,217.50
Total account balance as of 12/31/13 [($23,625–$7,500) × 105%]	=	$16,931.25
Earnings as of 12/31/2013	=	$ 7,713.75
Distributions in 2013	=	$ 7,875
Earnings ratio for 2013 ($7,713.75 ÷ $16,931.25)	=	45.6%
Earnings portion of distributions in 2013 ($7,875 × .456)	=	$ 3,591
Return of investment portion of distributions in 2013 ($7,875–$3,591)	=	$ 4,284

2014

Investment in the account as of 12/31/2014 ($9,217.50–$4,284)	=	$ 4,933.50
Total account balance as of 12/31/14 [($16,931.25–$7,875) × 105%]	=	$ 9,509.06
Earnings as of 12/31/2014	=	$ 4,575.56
Distributions in 2014 for qualified higher education expenses (QHEE)	=	$ 8,200
Distributions in 2014 not for qualified higher education expenses (Non-QHEE)	=	$ 1,309.06
Total distributions	=	$ 9,509.06
Earnings portion of QHEE distribution in 2014 [($8,200 ÷ $9,509.06) × $4,575.56]	=	$ 3,945.68
Return of investment portion of QHEE distribution in 2014	=	$ 4,254.32
Earnings portion of Non-QHEE distribution subject to penalty [($1,309.06 ÷ $9,509.06) × $4,575.56)]	=	$ 629.89
Return of investment portion of non-QHEE distribution in 2014	=	$ 679.17

(ii) In years 2011 through 2013 the designated beneficiary includes in gross income the earnings portion of the distributions for tuition. In year 2014 the designated beneficiary includes in gross income the earnings portion of the distribution for tuition, $3,945.68, plus the earnings portion of the distribution that was not used for tuition after reduction for the penalty, i.e. $535.41 ($629.89 minus a 15% penalty of $94.48).

(c) *Change in designated beneficiaries*—(1) *General rule.* A change in the designated beneficiary of a QSTP account is not treated as a distribution if the new designated beneficiary is a member of the family of the transferor designated beneficiary. However, any change of designated beneficiary not described in the preceding sentence is treated as a distribution to the account owner, provided the

account owner has the authority to change the designated beneficiary. For rules related to a change in the designated beneficiary pursuant to a rollover distribution see §§1.529–1(c) and 1.529–3(a)(2).

(2) *Scholarship program.* Notwithstanding paragraph (c)(1) of this section, the requirement that the new beneficiary be a member of the family of the transferor beneficiary shall not apply to a change in designated beneficiary of an interest in a QSTP account purchased by a State or local government or an organization described in section 501(c)(3) as part of a scholarship program.

(d) *Aggregation of accounts.* If an individual is a designated beneficiary of more than one account under a QSTP, the QSTP shall treat all contributions and earnings as allocable to a single account for purposes of calculating the earnings portion of any distribution from that QSTP. For purposes of determining the effect of the distribution on each account, the earnings portion and return of investment in the account portion of the distribution shall be allocated pro rata among the accounts based on total account value as of the close of the current calendar year.

§1.529–4 Time, form, and manner of reporting distributions from QSTPs and backup withholding.

(a) *Taxable distributions.* The portion of any distribution made during the calendar year by a QSTP that represents earnings shall be reported by the payor as described in this section.

(b) *Requirement to file return*—(1) *Form of return.* A payor must file a return required by this section on Form 1099–G. A payor may use forms containing provisions similar to Form 1099–G if it complies with applicable revenue procedures relating to substitute Forms 1099. A payor must file a separate return for each distributee who receives a taxable distribution.

(2) *Payor.* For purposes of this section, the term "payor" means the officer or employee having control of the program, or their designee.

(3) *Information included on return.* A payor must include on Form 1099–G—

(i) The name, address, and taxpayer identifying number (TIN) (as defined in section 7701(a)(41)) of the payor;

(ii) The name, address, and TIN of the distributee;

(iii) The amount of earnings distributed to the distributee in the calendar year; and

(iv) Any other information required by Form 1099–G or its instructions.

(4) *Time and place for filing return.* A payor must file any return required by this paragraph (b) on or before February 28 of the year following the calendar year in which the distribution is made. A payor must file the return with the IRS office designated in the instructions for Form 1099–G.

(5) *Returns required on magnetic media.* If a payor is required to file at least 250 returns during the calendar year, the returns must be filed on magnetic media. If a payor is required to file fewer than 250 returns, the prescribed paper form may be used.

(6) *Extension of time to file return.* For good cause, the Commissioner may grant an extension of time in which to file Form 1099-G for reporting taxable earnings under section 529. The application for extension of time must be submitted in the manner prescribed by the Commissioner.

(c) *Requirement to furnish statement to the distributee*—(1) *In general.* A payor that must file a return under paragraph (b) of this section must furnish a statement to the distributee. The requirement to furnish a statement to the distributee will be satisfied if the payor provides the distributee with a copy of the Form 1099–G (or a substitute statement that complies with applicable revenue procedures) containing all the information filed with the Internal Revenue Service and all the legends required by paragraph (c)(2) of this section by the time required by paragraph (c)(3) of this section.

(2) *Information included on statement.* A payor must include on the statement that it must furnish to the distributee—

(i) The information required under paragraph (b)(3) of this section;

(ii) The telephone number of a person to contact about questions pertaining to the statement; and

(iii) A legend as required on the official Internal Revenue Service Form 1099–G.

(3) *Time for furnishing statement.* A payor must furnish the statement required by paragraph (c)(1) of this section to the distributee on or before January 31 of the year following the calendar year in which the distribution was made. The statement will be considered furnished to the distributee if it is mailed to the distributee's last known address.

(4) *Extension of time to furnish statement.* For good cause, the Commissioner may grant an extension of time to furnish statements to distributees of taxable earnings under section 529. The application for extension of time must be submitted in the manner prescribed by the Commissioner.

(d) *Backup withholding.* Distributions from a QSTP are not subject to backup withholding.

(e) *Effective date.* The reporting requirements set forth in this section apply to distributions made after December 31, 1998.

§1.529–5 Estate, gift, and generation-skipping transfer tax rules relating to qualified State tuition programs.

(a) *Gift and generation-skipping transfer tax treatment of contributions after August 20, 1996, and before August 6, 1997.* A contribution on behalf of a designated beneficiary to a QSTP (or to a program that meets the transitional rule requirements under §1.529–6(b)) after August 20, 1996, and before August 6, 1997, is not treated as a taxable gift. The subsequent waiver of qualified higher education expenses of a designated beneficiary by an educational institution (or the subsequent payment of higher education expenses of a designated beneficiary to an educational institution) under a QSTP is treated as a qualified transfer under section 2503(e) and is not treated as a transfer of property by gift for purposes of section 2501. As such, the contribution is not subject to the generation-skipping transfer tax imposed by section 2601.

(b) *Gift and generation-skipping transfer tax treatment of contributions after August 5, 1997*—(1) *In general.* A contribution on behalf of a designated beneficiary to a QSTP (or to a program that meets the transitional rule requirements under §1.529–6(b)) after August 5, 1997, is a completed gift of a present interest in property under section 2503(b) from the person making the contribution to the designated beneficiary. As such, the contribution is eligible for the annual gift tax

exclusion provided under section 2503(b). The portion of a contribution excludible from taxable gifts under section 2503(b) also satisfies the requirements of section 2642(c)(2) and, therefore, is also excludible for purposes of the generation-skipping transfer tax imposed under section 2601. A contribution to a QSTP after August 5, 1997, is not treated as a qualified transfer within the meaning of section 2503(e).

(2) *Contributions that exceed the annual exclusion amount.* (i) Under section 529(c)(2)(B) a donor may elect to take certain contributions to a QSTP into account ratably over a five year period in determining the amount of gifts made during the calendar year. The provision is applicable only with respect to contributions not in excess of five times the section 2503(b) exclusion amount available in the calendar year of the contribution. Any excess may not be taken into account ratably and is treated as a taxable gift in the calendar year of the contribution.

(ii) The election under section 529(c)(2)(B) may be made by a donor and his or her spouse with respect to a gift considered to be made one-half by each spouse under section 2513.

(iii) The election is made on Form 709, Federal Gift Tax Return, for the calendar year in which the contribution is made.

(iv) If in any year after the first year of the five year period described in section 529(c)(2)(B), the amount excludible under section 2503(b) is increased as provided in section 2503(b)(2), the donor may make an additional contribution in any one or more of the four remaining years up to the difference between the exclusion amount as increased and the original exclusion amount for the year or years in which the original contribution was made.

(v) *Example.* The application of this paragraph (b)(2) is illustrated by the following example:

Example. In Year 1, when the annual exclusion under section 2503(b) is $10,000, P makes a contribution of $60,000 to a QSTP for the benefit of P's child, C. P elects under section 529(c)(2)(B) to account for the gift ratably over a five year period beginning with the calendar year of contribution. P is treated as making an excludible gift of $10,000 in each of Years 1 through 5 and a taxable gift of $10,000 in Year 1. In Year 3, when the annual exclusion is increased to $12,000, P makes an additional contribution for the benefit of C in the amount of $8,000. P is treated as making an excludible gift of $2,000 under section 2503(b); the remaining $6,000 is a taxable gift in Year 3.

(3) *Change of designated beneficiary or rollover.* (i) A transfer which occurs by reason of a change in the designated beneficiary, or a rollover of credits or account balances from the account of one beneficiary to the account of another beneficiary, is not a taxable gift and is not subject to the generation-skipping transfer tax if the new beneficiary is a member of the family of the old beneficiary, as defined in §1.529–1(c), and is assigned to the same generation as the old beneficiary, as defined in section 2651.

(ii) A transfer which occurs by reason of a change in the designated beneficiary, or a rollover of credits or account balances from the account of one beneficiary to the account of another beneficiary, will be treated as a taxable gift by the old beneficiary to the new beneficiary if the new beneficiary is assigned to a lower generation than the old beneficiary, as defined in section 2651, regardless of whether the new beneficiary is a member of the family of the old beneficiary. The transfer will be subject to the generation-skipping transfer tax if the new beneficiary is assigned to a generation which is two or more levels lower than the generation assignment of the old beneficiary. The five year averaging rule described in paragraph (b)(2) of this section may be applied to the transfer.

(iii) *Example.* The application of this paragraph (b)(3) is illustrated by the following example:

Example. In Year 1, P makes a contribution to a QSTP on behalf of P's child, C. In Year 4, P directs that a distribution from the account for the benefit of C be made to an account for the benefit of P's grandchild, G. The rollover distribution is treated as a taxable gift by C to G, because, under section 2651, G is assigned to a generation below the generation assignment of C.

(c) *Estate tax treatment for estates of decedents dying after August 20, 1996, and before June 9, 1997.* The gross estate of a decedent dying after August 20, 1996, and before June 9, 1997, includes the value of any interest in any QSTP which is attributable to contributions made by the decedent to such program on behalf of a designated beneficiary.

(d) *Estate tax treatment for estates of decedents dying after June 8, 1997*—(1) *In general.* Except as provided in paragraph (d)(2) of this section, the gross estate of a decedent dying after June 8, 1997, does not include the value of any interest in a QSTP which is attributable to contributions made by the decedent to such program on behalf of any designated beneficiary.

(2) *Excess contributions.* In the case of a decedent who made the election under section 529(c)(2)(B) and paragraph (b)(3)(i) of this section who dies before the close of the five year period, that portion of the contribution allocable to calendar years beginning after the date of death of the decedent is includible in the decedent's gross estate.

(3) *Designated beneficiary decedents.* The gross estate of a designated beneficiary of a QSTP includes the value of any interest in the QSTP.

§1.529–6 Transition rules.

(a) *Effective date.* Section 529 is effective for taxable years ending after August 20, 1996, and applies to all contracts entered into or accounts opened on August 20, 1996, or later.

(b) *Programs maintained on August 20, 1996.* Transition relief is available to a program maintained by a State under which persons could purchase tuition credits, certification or similar rights on behalf of, or make contributions for educational expenses of, a designated beneficiary if the program was in existence on August 20, 1996. Such program must meet the requirements of a QSTP before the later of August 20, 1997, or the first day of the first calendar quarter after the close of the first regular session of the State legislature that begins after August 20, 1996. If a State has a two-year legislative session, each year of such session shall be deemed to be a separate regular session of the State legislature. The program, as in effect on August 20, 1996, shall be treated as a QSTP with respect to contributions (and earnings allocable thereto) pursuant to contracts entered into under the program. This relief is available for contributions (and earnings allocable thereto) made before, and the contracts entered into before, the first date on which the program becomes a QSTP. The provisions of the program, as in effect on August 20, 1996, shall apply in lieu of

section 529(b) with respect to such contributions and earnings. A program shall be treated as meeting the transition rule if it conforms to the requirements of section 529, §§1.529–1 through 1.529–5 and this section, by the date this document is published as final regulations in the **Federal Register.**

(c) *Retroactive effect.* No income tax liability will be asserted against a QSTP for any period before the program meets the requirements of section 529, §§1.529–1 through 1.529–5 and this section, if the program qualifies for the transition relief described in paragraph (b) of this section.

(d) *Contracts entered into and accounts opened before August 20, 1996—* (1) *In general.* A QSTP may continue to maintain agreements in connection with contracts entered into and accounts opened before August 20, 1996, without jeopardizing its tax exempt status even if maintaining the agreements is contrary to section 529(b) provided that the QSTP operates in accordance with the restrictions contained in this paragraph (d). However, distributions made by the QSTP, regardless of the terms of any agreement executed before August 20, 1996, are subject to tax according to the rules of §1.529–3 and subject to the reporting requirements of §1.529–4.

(2) *Interest in program pledged as security for a loan.* An interest in the program, or a portion of an interest in the program, may be used as security for a loan if the contract giving rise to the interest was entered into or account was opened prior to August 20, 1996 and the agreement permitted such a pledge.

(3) *Member of the family.* In the case of an account opened or a contract entered into before August 20, 1996, the rules regarding a change in beneficiary, including the rollover rule in §1.529–3(a) and the gift tax rule in §1.529–5(b)(3), shall be applied by treating any transferee beneficiary permitted under the terms of the account or contract as a member of the family of the transferor beneficiary.

(4) *Eligible educational institution.* In the case of an account opened or contract entered into before August 20, 1996, an eligible educational institution is an educational institution in which the beneficiary may enroll under the terms of the account or contract.

Michael P. Dolan,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on August 21, 1998, 8:45 a.m., and published in the issue of the Federal Register for 63 F.R. 45019)

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C.—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contribution Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedral Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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